

**THE INTRODUCTION OF VALUE ADDED TAX LEGAL SYSTEM
IN LESOTHO WITH PARTICULAR EMPHASIS ON ITS
ADMINISTRATION AND IMPLEMENTATION**

Thesis submitted for the Award of the Degree of Ph.D

By

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DECLARATION

I, the undersigned declare that this thesis has been composed by me and is a record of my work. No part of it has been submitted for another degree or professional qualification at this or any other University.

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ABSTRACT OF THESIS

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Title of Thesis: The introduction of value added tax legal system in Lesotho with particular emphasis on its administration and implementation

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The introduction of VAT in Lesotho marks a change of tax regime, from a single-stage tax (sales tax) to a multiple-stage tax (value added tax). The main issues which led to the change of regime are; the decline in Lesotho's share of revenue from the Southern African Customs Union 'pool'; the restrictive nature of the legal features of sales tax; and the administration problems and inefficiencies which undermined the implementation of sales tax. The main question which this study investigates is whether the introduction of VAT law system in Lesotho is successful and efficient. VAT is generally viewed as a modern tool towards achieving a stable and an efficient tax system. The VAT system in Lesotho is critically analysed on the basis of how VAT as a 'tax' has developed. The main focus is on the administration of the tax. The main components which are used to evaluate the system are; - the legal structure of the tax and the administration strategies for its implementation. These components of the VAT system are evaluated through the use of library research tools and fieldwork research tools. The fieldwork research tools focused on two aspects; the administration and implementation of VAT; and the practical aspect of compliance by the business entities. The use of these tools is to critically analyse salient features of the Lesotho VAT system.

Chapter 1 is an introductory chapter and lays out background information on the geographical; economic and taxation system of Lesotho. The main highlight is the geographical nature of Lesotho as a landlocked country and how that shapes its economic and taxation situation. Chapter 2 analyses the principles and features of a VAT; and deals with a comparison of VAT and sales tax. Chapter 3 analyses the legal structure of VAT in Lesotho. Chapter 4 deals with the establishment of the Lesotho Revenue Authority and the administrative implementation of VAT. Chapter 5 analyses the practical aspect of the implementation; and compliance with VAT. Chapter 6 examines issues of cross-border trade in the implementation of VAT in Lesotho. Chapter 7 is the general conclusion.

DEDICATION

To my son 'NENA, who has been strong and understanding during the period of my studies even when I could not be there for him at all times.

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ABBREVIATIONS

BLNS	Botswana, Lesotho, Namibia and Swaziland
CCU	Car Clearance Unit
CMA	Common Monetary Area
DCU	Debt Collection Unit
ECJ	European Court of Justice
ELS	Electronic Lodgement Service
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FBI	Filing by Internet
FAO	Food Agriculture Organisation
GDP	Gross Domestic Product
GNP	Gross National Product
GST	Goods and Services Tax
IMF (FAD)	International Monetary Fund (Fiscal Affairs Department)
LHWP	Lesotho Highlands Water Project
LRA	Lesotho Revenue Authority
MOF	Ministry of Finance
NRA	National revenue authority
OECD	Organisation for Economic Co-operation and Development
PRGF	Poverty Reduction and Growth Facility
RPU	Return Processing Unit
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAF	Structural Adjustment Facility
SARS	South African Revenue Services
SET	Selective Employment Tax
TIN	Taxpayers Identification Number
TRA	Tanzania Revenue Authority
UGA	Uganda Revenue Authority

UK	United Kingdom
VAT	Value Added Tax
VIPS	Value Added Tax Information Processing System
WFP	World Food Programme
ZRA	Zambia Revenue Authority
WTO	World Trade Organisation

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4. *Mol v Inspecteur de Invoerrecht en Accijnzen* CJEC case 269/86 (1988) ECR 3627
5. *R v Goodwin and Unstead* CJEC case C3-/97 (1988) STC 699
6. *Staatssecretaris van Financiën v Shipping and Forwarding Enterprise SAFE BV* (Case 320/88) (1990) I ECR 285; (1991) STC 627
7. *Tolsma v Inspecteur der Omzetbelasting Leeuwarden* C-16/93
8. *TP Madgett and RM Baldwin v Customs and Excise Commissioners*, CJEC [1998] STC 1189 (TVC 21.275)
9. *Van Dijk's Boekhuis v Staatssecretaris van Financiën* (Case 139/84) [1986] 2 CMLR 575
10. *Vereniging Happy Family Rustenburgstrat v Inspecteur der Omzetbelasting* CJEC case 289/86 (1988) ECR 3655
11. *Witzemann v Hauptzollamt Munchen-Mitte* CJEC 1990; [1993] STC 108

Chapter 1: General Introduction

1.1 Introduction

This chapter introduces the topic of research, the main theme of the research and the questions which form the basis of this study. The topic for the study is the introduction of Value Added Tax (VAT) in Lesotho, with particular focus on the administrative aspect of implementing the system. This is discussed from the point of view of the change of regime from sales tax to VAT and the administrative issues and challenges during that process. The chapter outlines the objective of the research and explains the motivation for engaging in this research study. The approach which is used is to highlight the main themes of the study and how they are investigated through various research methods and other tools to fit into the topic. The chapter identifies and sets out the core problems which the study investigates and are the main theme of the research. Secondary themes which arise from the major questions are also discussed.

Furthermore, the chapter sets out the methodology which has been adopted to carry out the research for the study. The methodology outlines how the research was carried out from the different sources which have been used. It also sets out how the fieldwork research was carried out in Lesotho and how the data is used in the study. The methodology further details the approach which was adopted to carry out the library based research and how the information from such sources is used in the study. The chapter also sets out how the study is divided and what each part focuses on. The aim is to identify how the themes are divided and identify which theme or themes each part deals with.

Lastly, the chapter lays background information on the geographical and economic situation of Lesotho. The objective of this part is to outline background information of Lesotho as a country with particular focus on its geographical status and economic status; both of which impact on its taxation policies and laws. The discussion

also highlights the status of Lesotho in respect to its international and regional obligations which arise from the international agreements to which it is a party. The relevance of this latter part is to establish the impact and the contribution of these regional and international organisations to the economic and taxation situation of Lesotho.

1.2 The Choice of Topic and Motivation of Study

The present study focuses on the tax reforms which were introduced by the government of Lesotho and resulted in the shift in the indirect tax regime from general sales tax to value added tax. This regime change resulted in the introduction of VAT in July 2003 to replace a sales tax. The objective of this study is to examine this regime change from sales tax to VAT in Lesotho, particularly focusing on issues of administration in implementing the tax. To achieve this aim, there are various questions and themes which are investigated which are relevant to the main theme. The approach which is adopted in this study is to critically examine and review the legal structures and legal jurisprudence on sales tax and VAT with particular focus on administrative requirements.

VAT is viewed as a modern tool towards achieving a stable and efficient tax system. It has also been viewed as having a “greater revenue potential than its alternatives.”¹ Furthermore, VAT is viewed as a means to improve and strengthen the tax administration of other taxes and this was one of the prevalent views in introducing VAT in Lesotho. The government aimed at strengthening the tax administration of all the taxes,² that is income tax, excise and customs duties and company tax and this resulted in the establishment of a semi-autonomous body, Lesotho Revenue Authority (LRA) which is responsible for the administration and implementation of VAT. LRA also has the responsibility to administer and collect all the other taxes in Lesotho. This is a significant change in the administration and collection of taxes in Lesotho, as

¹ Tuan Mihn Le, “Value Added Taxation: Mechanism, Design, and Policy Issues” *Paper prepared for the World Bank course on Practical Issues of Tax Policy in Developing Countries* (Washington D.C., April 28-May 1, 2003) p.6

² King, J., Walsh, J.T., and Laycock, I., “Lesotho: Implementing the VAT and Strengthening Tax Administration” *Fiscal Affairs Department: International Monetary Fund*, July 2000 p.12

previously this was the responsibility of the tax departments which were part of the Ministry of Finance (MOF). Therefore, tax collection and administration was formerly the responsibility of the government directly.

The question which has to be investigated is what are the challenges which face the administration as a result of the change from sales tax to VAT? For purposes of investigating this issue, it is important to examine the aims, problems and challenges of the administration before and after the implementation of VAT. The approach which is adopted involves examining the administration strategies and measures which were introduced by LRA (to be implemented by the VAT Division) and their approach towards administration of VAT. This discussion leads to the main question of the present study which is, whether the introduction of VAT has been successful in Lesotho and whether it has been efficient in addressing the fiscal problems which undermined the sales tax regime.

The study also examines some views (which have come up in various academic works, other types of literature sources and also in the fieldwork research which I carried out) which arise from the nature and structure of VAT. First, there is a view that VAT is complex in its structure as a tax. It is argued that a VAT system with multiple rates and many exclusions (in the form of both zero-rating and exemptions) will be more complex to administer and to comply with, than a VAT with one rate. Second, it is argued that VAT is more costly to administer and comply with than the taxes it has replaced. On the basis of these views, the study investigates whether a VAT can be effectively implemented in a developing country (where there are problems such as shortage of skilled and professional tax experts, technological resources for the administration to effectively establish a single database for tax information or to exchange information electronically, the lack of a tax culture and nature of the economy which comprises mainly of informal sector). These problems can undermine the effective implementation of VAT. The relevance of these points arises from the fact that the main focus of the study relates to the implementation of VAT in Lesotho which is a developing country.

Furthermore, another view is that the cost of administering and complying with VAT is higher than in relation to the taxes which it replaces. This is due to the fact that it is collected at each stage of production and distribution. It requires that traders issue invoices with each transaction and keep a record of their own purchases and sales. They have to keep up to date accounts and audit their books regularly. These processes have an impact on the costs as they involve a number of administrative issues. In this study, it is argued that the costs of complying with a VAT are higher for medium and small firms than for big firms. This aspect of compliance costs for small firms is discussed in the context of Lesotho and compared to the position in the UK. It is also argued that due to the nature of the economy of Lesotho, (which has a high number of small and medium business entities which are mostly outside the compulsory VAT tax net) most business entities have chosen to register for VAT. However, the consequences of registration are similar for all business entities, irrespective of the size of the entity.

The other point which arises as secondary from the main theme is the impact of VAT on cross border trade in Lesotho and the administration issues which are involved. The Lesotho VAT system is based on a destination principle in dealing with cross border trade transactions. The study examines the cross-border trade issues which are pertinent to the situation of Lesotho and are mainly shaped by the fact that Lesotho is a landlocked country within South Africa. The important point for discussion is how to charge VAT on the cross border trade transactions which arise. This issue is discussed with reference to international taxation principles which apply to cross-border trade transactions namely, the origin and destination principles.

In view of the identified problems and the themes which form the basis of this research work, it appears that the present study is motivated by the tax reform measures in relation to the introduction of a VAT in Lesotho and the establishment of a semi-autonomous body for administration of VAT and other taxes.

1.3 Tax Structures and Different Types of Tax

Tax systems differ all around the world as they are dictated partly by existing economic conditions in each country. Therefore as these conditions tend to differ, the tax systems also differ. The factors which are relevant include the level of economic development and the fiscal structures within an economy. The existence of these factors defines the nature and type of a tax system a country adopts. Furthermore, a tax system can also be influenced by external factors. For example, powerful neighbours are likely to influence the type of tax system which is adopted in a neighbouring country. This means a smaller country is likely to adopt a similar tax system as the bigger and more powerful neighbouring country in order to overcome problems which are caused by different tax systems between neighbouring countries. These would include smuggling, cross-border shopping and “brain drain” (where people cross the border to take up jobs in the neighbouring country).

For example, this appears to be the case in relation to Lesotho and South Africa. The VAT system in Lesotho has to some extent been influenced by the VAT system in South Africa. This is seen particularly in the introduction of VAT at the same rate as the rate in South Africa, as a way to avoid some of the problems which existed when Lesotho had a different rate for sales tax from the rate of VAT in South Africa.³

Regional or international organisations also influence the tax systems of the member countries, as it is likely that such a grouping of states share all or some geographical, economic (political) or social interests. Therefore, it is easy for these countries to ensure that their tax systems reflect the objectives of the group or the organisation. (For example this is the case in economic groupings and customs unions such as the European Union (EU) and Southern African Customs Union (SACU)). This seems to be the case in Lesotho with the introduction of VAT. It emerged from the government authorities during the preparatory process that the move from sales tax to

³ An address by the Minister of Finance and Development Planning to the Business Community on the Introduction of VAT in Lesotho, May 2003. These problems are discussed in chapter 7

VAT (and setting of the rates) is in accordance with their obligations under the SACU Agreement.⁴

Furthermore, changes within the global economy are most likely to influence tax systems in both developed and developing countries. These changes are important for the taxation systems of all countries. The tax system in each country is structured in a way that it fits in with the fiscal, social, cultural and political policies in that country. Though tax systems differ, their functions and their objectives are in many ways similar in all countries.

The two major theories of taxation which form background to this study are: - income based taxation and sales expenditure taxation. Income based taxation is used to refer to direct taxation while sales expenditure taxation is used to refer to an indirect taxation system. The concepts are used interchangeably in this discussion.

1.3.1 Direct Tax

The concept is used to refer among others to income tax, corporation tax, social security tax (or council tax) and capital gains tax. These taxes are borne by and collected from individuals and legal entities on the basis of earning an income.⁵

The most distinguishing factor of direct taxes is that they are imposed on an individual and an entity which directly bears the tax. This is clearly expressed in the following definition, 'Direct taxation is defined as taxation imposed upon the person who is intended to be the final bearer of the burden of payment'.⁶ The burden of tax lies with the person who has to make the final payment which for example can either be an employee in the case of income tax or an entity in corporation tax. Direct taxes rely on the individuals' income, savings and other individual circumstances like family situation to determine the deductions and exemptions. 'A feature that direct taxes share is that the

⁴ Ibid

⁵ Income includes proceeds from realizing capital and the profit thereof. In countries which tax capital gains it can be argued that the gains (income and profit) from capital assets are both taken as income and therefore they are taxable as income tax.

⁶ James, S., and Nobes, C., *The Economics of Taxation: Principles, Policy and Practice*, 7th edition (Pearson Education Ltd: England) 2000 p.20

amount of tax can be related to individual circumstances, for example, the taxpayer's commitments or family size',⁷ whereas this is not the case with indirect taxes.

1.3.2 Indirect Tax

Indirect tax is defined as a tax which is 'not levied directly upon the person on whom it ultimately falls, but charged in an indirect way, especially upon the production or importation of articles of use or consumption, the price of which is thereby augmented to the consumer, who pays the tax in form of increased price' (English Oxford Dictionary). According to this definition indirect tax is imposed upon others than the person who is intended to bear the final burden. The tax ultimately falls on the consumer and is borne by him, though in some instances the tax is collected by traders on behalf of the revenue office (in the case of sales tax and VAT).

In practice it seems that most countries tend to use a combination of both indirect and direct taxation systems. This can be justified in that most countries prefer to distribute the burden of taxation across all the different groups. In this study focus is on the choice between the different types of sales based expenditure taxation, that is, between multiple – stage taxes (VAT) and single – stage taxes (sales taxes).

The two main tax structures which are important in this study are VAT and sales tax. The concept behind value added tax derives from the way the liability of the tax arises and the method of collection of the tax. VAT is charged on goods and services which are for final consumption. It is charged on the 'value added' at each stage of production and is therefore known as a multi-stage tax. It is provided that 'taxing on a value added basis' "ensures that each input into the final consumer output is taxed only once, as tax paid on inputs at a previous stage in production may be rebated".⁸ This mechanism of avoiding tax being charged on previously charged tax by rebate has resulted in VAT being favoured over other types of consumption taxes.

⁷ Ibid p.13

⁸ A report by the National Economic Development Office, *Value Added Tax*, 1969 p.8

This concept of value added tax is commonly used by most countries, (including the EU member states and countries in the Sub-Saharan region for example, Lesotho and South Africa) though some countries employ a different terminology. For example, countries such as Australia and New Zealand refer to their value added tax as 'Goods and Services Tax' (GST). It has similar attributes to a VAT; the only difference is in the terminology.

The other structure which is widely used in this study is sales tax. It is a single-stage tax as it is collected at one stage of production which can either be the manufacturer's stage, wholesaler's stage or the retail stage. Sales tax applies to the sale for final consumption if it is at the retail stage. This final purchaser may either be an individual consumer or a business firm purchasing for its own use rather than for resale or a small retailer not required to register.⁹ The basis of taxation under such a sales tax is the retail price. Sales tax may not only cover retailers, but all other entrepreneurs dealing directly with private consumers. The relevance and use of this concept in this study arises from the fact that most countries adopted a VAT to replace some kind of a sales tax. This was the case in Lesotho, where VAT replaced a general sales tax.

1.4 Methodology and How the Thesis is Divided

1.4.1 Methodology

The methodology of research which is used in the study is a combination of library based research and fieldwork research. The fieldwork research was carried out in Lesotho and it was undertaken in two stages. The first stage was an internship at the LRA based in the VAT Division. This part of the research focused on acquiring information on the administrative aspect of implementing VAT which includes the studies which led to the introduction of VAT and the aims, problems, successes, and challenges.

⁹ Due, J.F., *Indirect Taxation in Developing Economies: The Role and Structure of Customs Duties, Excises and Sales Taxes* 1970 (The John Hopkins Press: USA) p.102

The second stage of the fieldwork involved carrying out a survey of the business community (business entities or traders) with particular focus on those that are registered. A small but reasonable number of small business entities (that are registered) did participate in the survey. The method of research which was used to carry out the survey with the business community was through the use of questionnaires which were distributed to the various categories of traders. The objective was to get the views of the business entities on various aspects of the practical impact of VAT particularly the administration aspect. A more detailed analysis of the methodology of the survey and fieldwork is included in chapters 4 and 5.

The library based research includes reference to books, journals (including online journals and publications), periodicals and case books including on-line legal research and sources from the various libraries which were consulted. The main research was carried out at the Law and Europa library of The University of Edinburgh. Some of the published material was accessed through the inter-library loan facility which is available at the University libraries. While the research was on-going, I identified further sources from the Bibliographies and reference sections of books, journal articles and periodicals. The information from these sources was summarised and classified according to which areas it dealt with; how and where it fits into the themes of the study. The information is used mainly to identify and analyse the principles and structure of VAT; the implementation of VAT with particular focus on the administrative aspect; the applicability of a VAT in small and developing countries; and the impact of VAT on cross border trade. The analysis of the principles and the structure of VAT is related to the implementation of VAT in Lesotho. The investigation into the specific issues and principles that are actually part of the VAT system in Lesotho is supported with the use of the empirical data from the fieldwork research.

The analysis of the themes in this study is intended to focus on the change of tax regime, from sales tax to VAT in Lesotho. The focus is restricted to VAT and sales tax because VAT was introduced to replace sales tax in Lesotho. The objective of this choice of focus is to examine the administrative challenges and the challenges of implementing VAT in Lesotho. The research also demonstrates that existing economic

conditions in each country as well as the tax system have an important role to play in effective administration of a VAT. Furthermore, it appears that the administrative challenges are also influenced by the structure of the tax.

1.4.2 How the Thesis is Divided

The study is divided into four parts apart from this Introduction (Chapter 1) which details out the main issue of the thesis and the question which the thesis investigates. Part One has one chapter. Chapter 2 examines the role of the IMF in tax reforms and the introduction of VAT particularly in developing countries. The relevance of this discussion is to investigate and analyse the role of the IMF in tax reforms which have led to the introduction of a VAT in a number of countries particularly in Lesotho. Furthermore, the structure and principles of VAT and sales taxes are discussed. This leads to the comparative aspect of the two types of tax structures with emphasis on the failure of the sales tax system in Lesotho.

Part Two of the study focuses on the various aspects of the VAT system in Lesotho and it is divided into chapters 3, 4 and 5. Chapter 3 deals with an extensive analysis of the legal framework and structure of VAT in Lesotho. It sets out the principles of the tax as developed in the VAT Acts and the Regulations. These principles are discussed in the context of general practice on identification of the nature and structure of VAT. Furthermore, these principles are discussed with the aid of examples from decided cases from other jurisdictions with similar legal systems, for example South Africa and the UK. The cases are used to define and interpret the terms which are used in the legislation which are capable of raising controversy in the classification of a transaction. Emphasis in this discussion is on how the principles of VAT are likely to be interpreted by the courts in Lesotho, where the interpretation in the legislation is not clear or is capable of more than one meaning.

Chapter 4 examines the administrative framework of VAT and the change of the administrative structure to a national revenue authority. It also investigates the reasons why the government opted to establish a national revenue authority to administer

collection of taxes in Lesotho. It is argued that a national revenue authority is more efficient in the administration and collection of taxes, where sufficient resources (qualified staff and financial resources) are invested. However, on the other hand, it is also highlighted that the establishment of a national revenue authority by itself does not necessarily result in improved administration and increase in revenue collection.

Moreover, the chapter also focuses on the main administrative requirements for implementing VAT. These include undertaking preparatory measures prior to the implementation of the tax. The discussion goes further to examine the implementation process of VAT and reviews the administrative challenges under VAT since its introduction in July, 2003.

The other important theme which this part deals with is the practical impact of the introduction of VAT. This is dealt with in chapter 5 which focuses mainly on the impact of VAT on business entities and the administration processes. The objective of this chapter is to investigate the practical impact of VAT on business entities and the administrative impact of implementing the tax on those who are directly involved in charging and collecting VAT.

Part Three has one chapter which is chapter 6. This chapter deals with issues of cross-border trade and the administration of VAT in such cases. The main question in this part is to consider the role of VAT in cross border trade and the challenges which cross border transactions pose for administration of VAT in Lesotho. The discussion relies on the relevance of international principles of taxation which apply in cross-border transactions. The EU VAT system is used as an example of how the principles apply in practise.

The general conclusion of the study is dealt with in chapter 7. This chapter presents a summary of the main arguments which form the basis of the study. It further identifies the core principles of this study and how they apply to the main themes. In this part, I also highlight the major arguments and summarise the theories which arise from the discussions in the various chapters. The chapter draws conclusions from the previous parts which are related to the introduction of VAT in Lesotho and the administrative challenges to the system.

This part concludes by answering the question whether the introduction of VAT in Lesotho has been successful and whether the change of regime from a sales tax to VAT regime has also been efficient to the Lesotho tax system. I conclude by highlighting relevant issues to the VAT system in Lesotho which need further investigation and can be areas of further research in future studies.

1.5 Background Information on Lesotho's Economic, Geographical and Regional Position

1.5.1 The Economic and Geographical Position of Lesotho

The Kingdom¹⁰ of Lesotho (Lesotho) is a small landlocked country situated in Sub-Saharan Africa. Lesotho has a unique situation as it is entirely surrounded by the Republic of South Africa (South Africa). The situation of Lesotho is unique (in the World) as it is surrounded by one country. There are clear demarcations of boundaries between the two countries which is why it is unique in International law in respect of landlocked states.¹¹ The boundaries between Lesotho and South Africa are represented by a river in some parts, while in other parts a fence is used as demarcating a boundary between the two countries. There are nine border posts between these countries. At some of these border posts, the immigration posts of the two countries are about 3 km (estimation) apart or slightly less in others. These indicate the fact that the two countries are geographically very close.

¹⁰ Lesotho gained independence from the United Kingdom on 4th October, 1966 and became a Kingdom. It has a constitutional monarch, King Letsie III as head of state and the executive powers lies with the government (democratically elected) led by the Prime Minister. The Parliament in Lesotho has two houses, a lower house, National Assembly (120-seats since 2002 and members are elected through national elections after every 5 years) and an upper house, the Senate with 22 principal chiefs (Chiefs as duly appointed under the Chieftainship Act by the King on the advise of the College of Chiefs) and 11 other persons nominated by the King.

¹¹ One is aware of the position of The Vatican City but a distinction can be drawn between this case and the case of Lesotho in the sense that geographically the Vatican City is part of Italy whereas Lesotho is a separate and independent country geographically from South Africa. Similarly, we are aware that San Marino is another landlocked country within Italy, however, since San Marino is an enclave, it has some kind of access through the sea to third countries.

In size Lesotho is 30,355 sq km (11,720 sq mi) of mainly mountainous territory and is situated at approximately 5,000 to 11,000 ft above sea level.¹² Lesotho has a small population of 1.96 million.¹³ The people of Lesotho are called Basotho and they are of southern Sotho origin. The official languages in Lesotho are Sesotho and English.

Over 80% of the resident population live in the villages and engages in subsistence farming (and other informal sector activities), but agriculture accounts for just 20% of gross domestic product (GDP) and basic foodstuffs must be imported. Most of Lesotho's arable land is in the west of the country and is about 13 percent of the total land area.¹⁴ The land is highly populated due to a growing population and this has also contributed to some of the economic problems in the country. This has led to land shortage particularly for agricultural purposes; soil erosion; and decline in domestic live stock particularly cattle and sheep.

Maize is the staple crop in Lesotho, but sorghum, beans, dry peas, wheat, and sunflower oil are also cultivated. Summer wheat is the only export crop for Lesotho, most going to South Africa. Cattle exports, along with wool and mohair, also contributed to the agricultural earnings of the country in the 1990's, but this sector of the economy has declined drastically due to shortage of land for grazing and periodic droughts which have hit Lesotho (and the whole Southern African region) in the last 10 years.

Lesotho's major export continues to be labourers to South African mines, farms, and industry; roughly 35% of Lesotho's adult male wage-earners work in South Africa.¹⁵ Up to 60% of annual household income is derived from migrant remittances, which also represent 45% of Lesotho's gross national product.¹⁶ From the economic side, Lesotho's economic performance from the early to mid 1990's saw an economic boom that was

¹² *FAO Special Report in Lesotho* - compiled by FAO/WFP Crop and Food Supply Assessment Mission to Lesotho, June 2005 www.fao.org/documents site visited on 21st April, 2006

¹³ This is as of June 2006 following a population census in May, 2006 –information available from www.bos.gov.ls

¹⁴ *EU Development report*, June 2005

¹⁵ About half the income of rural households comes from family members working in mines and other jobs in South Africa, but these remittances are declining with falling employment due to restructuring in the South African mines and changes in migration policies.

driven by the construction of the Lesotho Highlands Water Project (LHWP)¹⁷ and the expansion of the manufacturing and textile sectors. The GDP grew at an annual average rate of 6.3 percent. However there was a severe reduction of the GDP growth between 1998 and 1999 resulting from civil unrest in the country. Growth resumed in 1999-00 and 2000/01, but at a slower pace of 2.4 percent and 3.2 percent respectively. Major contributors to GDP growth in 2000/01 were agriculture at 15 percent, manufacturing and construction at 40 percent and services at 36 percent. The textile industry benefits particularly from the US African Growth and Opportunities Act of 2000.¹⁸ Taiwan, Hong Kong and Singapore are the important investors in this sector. This sector saw a lot of factories closing when the World Trade Organisation's (WTO) Multi-Fibre Agreement (MFA) expired in 2005. This Agreement (30 years old) was established to protect smaller textile industries in developing countries' competition from Chinese exports particularly to the US market. The closure of these factories resulted in loss of jobs in the country and this had a tremendous impact on the economy. However, recent reports¹⁹ indicate that the textile industry is slowly coming back since most of the factories which had been closed have reopened as a result of an increased market for some products which are manufactured in Lesotho from the US and recently from Europe.

A notable development in recent years has been the growth of export-oriented manufacturing, led by the clothing and footwear sub-sector. The main destinations of Lesotho's exports are North America (particularly the United States) which amount to 76 percent of total exports (mostly textiles) and the Southern African Customs Union

¹⁶ Report from the Lesotho Prime Minister's office, Encyclopedia of the Nations - Lesotho Forum 2003, www.britannica.com/eb/article-9109707

¹⁷ LHWP is a result of the Lesotho Highlands Water Project Treaty between Lesotho and South Africa which was signed in 1986. The objective of the project is that Lesotho will deliver water from the highlands to the Vaal River system in South Africa by the year 2020 and Lesotho would benefit by developing its own hydroelectric power. The project was meant to be developed in a number of phases and Phase 1A and Phase 1B of the project have now been completed.

¹⁸ Under this Act eligible African economies qualify for duty free access to the United States for most products. For a limited period AGOA rules of origin are more lenient for exports from less developed African economies including Swaziland and Lesotho. Producers in these countries can use fabric from third countries.

¹⁹ IRIN News, [IRINnews.org-www.globalgoodnews.com/business-news.html](http://www.globalgoodnews.com/business-news.html) and <http://allafrica.com/stories/20060731029.html>, sites visited on 12th July, 2006

(SACU) countries which comprises of 26.2 percent; while exports to the EU represent 0.5% of total exports. On the other hand the main sources of imports are South Africa which account for 73 percent and Asia at 14.9%.²⁰

On the monetary side, Lesotho's fiscal and monetary policies operate within the context of its membership to the Common Monetary Area (CMA).²¹ In terms of the CMA Agreement, the Lesotho's national currency, *loti* (*Maloti* in plural) is fixed at par to the South African rand (this means 1 *Loti* is equivalent to 1 South African Rand). The CMA uses the South African Rand as a common currency, although each member state issues its own currency as well. As a result CMA has sometimes been referred to as the "Rand Zone" because of the use of "rand" and since also the South African Reserve Bank plays a crucial role in the monetary policies of each member state.²² The South African rand is therefore legal tender and co-circulates with the *loti* in Lesotho.

It seems that the position of Lesotho as a landlocked country has resulted in more problems than achievements, however on a positive side it appears that recent initiatives for greater co-operation between South Africa and Lesotho in the areas of water management, trade and development, political and economic relations will bring benefits to the two countries. On the other hand it is important to point out that the geographical constraints, combined with the growing population have had drastic effects on the economic situation of Lesotho. This has led to Lesotho's economic future being linked to that of South Africa.

At the regional and sub-regional level, it appears that initiatives to achieve shared resources; joint facilities; free movement of goods, services and people under SACU and SADC²³ are important factors both for present development activities and for closer future integration. Furthermore, the membership of CMA in the same way has created

²⁰ See *EU Development report*, op.cit.

²¹ The other member states of CMA are Namibia, Swaziland and South Africa

²² Sparks, D.L., "The Future of Monetary Integration in Southern Africa: Will SADC Join the Rand Monetary Area?" *Paper Presented to the Conference on Exchange Rates, Economic Integration and the International Economy Exchange Rates*, Ryerson University Toronto, Canada May 17-18 2002 p.1 at www.sarp.org.za/documents/d0000914/IRRD_confronting_the_Region_2004_reg_integration.pdf

²³ SADC is a regional organisation whose membership comprises of Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe. It was established in 1980

fiscal and monetary advantages and opportunities for future development of policies and activities within the member states.

1.5.2 Lesotho's Tax System and Revenue Performance

The direct taxes which are part of Lesotho's tax system are income tax; corporation tax; withholding tax; and capital gains tax while indirect taxes are VAT; customs and excise duties; and stamp duty. Income taxes in Lesotho experience similar problems to those in other developing countries of complexity; applicability only to a small proportion of individuals with an income above a set minimum bracket – as the level of unemployment is high and most people are not even close to the income tax minimum, this results in income tax being concentrated on a small proportion of people and most tax on profits is paid by companies and corporations under corporation tax. Customs and excise duties in Lesotho are subject to the SACU agreement and how these duties are determined and collected in each member state.

The collection of revenue particularly of income tax, improved steadily during the 1990's. However, there was no significant contribution seen from the indirect taxes – mainly Sales Tax. It contributed about 3.5 - 3.7 percent of the gross national product (GNP) from 1994/95 until 2000/01. Further, Lesotho benefited from the customs and excise revenues from the SACU 'pool' which accounted in 1994/95 for well over half of the total government revenues and almost two-thirds of tax revenues. This pattern steadily declined by 2 percent of GNP between 1995/96 and 1999/2000 from 19.7 percent in 1994/95 to 16.5 percent in 1998/99 and 17.7 percent (of revenue from the pool) in 2000/01.²⁴ It became clear at this time that in the long run the decline in Lesotho's receipts from the SACU customs and excise revenue 'pool' as a percentage of GNP could be expected to continue. There were two contributory factors which led directly to the decline: firstly, Lesotho's receipts were boosted to a high level in the 1990's by the imports associated with phase 1 of LHWP which project was then completed; and secondly, the process of trade liberalization in Southern Africa,

including the free trade agreement between South Africa and the EU which also applies to the other SACU members were expected to lead to the decline of import duties and customs revenue by 5 percent.²⁵

The revenue performance of VAT is discussed in chapter 4, though there was not sufficient data to compare it with its predecessor (sales tax). Furthermore, it seems foreign aid (grants) from international donors has also been an important source of revenue in Lesotho. However, this is one area which is highly unreliable and does not have long term prospects. Therefore, the government cannot rely solely on foreign aid as source of revenue.

Like most countries, tax revenue in Lesotho forms a significant contribution to the total revenue and grants collection. This means that the government is expected to raise substantial revenue from the different kinds of tax.

From this background it can be concluded that Lesotho's economic and geographical position does indicate the level of dependence of a landlocked country on its neighbouring country. Lesotho depends on South Africa for its trading activities with the other countries. This means for its imports and exports it depends on transit routes in South Africa for transportation; infrastructure; administrative arrangements; and other practicalities. Using the Lesotho situation as an example, it is clear that landlocked countries are faced with challenges in their overall development and in cross-border trade issues as they are dependent on their transit neighbours.²⁶

²⁴ Ministry of Finance Yearly Reports 1995-2001

²⁵ Kirk, R., and Stern, M., "The New Southern African Customs Union Agreement" June 2003 p.7 www.worldbank.org/afr/wps/wp57.pdf site visited on October, 2003

²⁶ For further discussion on the challenges which face landlocked developing countries, see Faye, M., McArthur, J., Sachs, J., and Snow, T., "The Challenges Facing Landlocked Developing Countries" *Journal of Human Development* Vol.5 No.1 2004 pp.31-68

1.5.3 Lesotho and the Southern African Customs Union (SACU)²⁷

Lesotho is a member of SACU and it is bound by the SACU agreement in regulating its customs and excise tariffs. Similarly, even in other changes to the tax system as a whole, it has to take into consideration the tax systems of the other member countries within the customs union. The defining characteristic of this Customs Union is identified as the economic dominance of South Africa in contrast to the size of the other four members.²⁸ These countries depend heavily on South Africa for a significant proportion of their trade, investment and employment in some cases – migrant labour was the most common one, but this has declined considerably since the 1990s.

SACU's main focus is on facilitation of trade and cross-border movement of goods by removal of trade barriers for the free movement of domestic products within the member states.²⁹ This means that goods which are grown, produced or manufactured in the customs area, on importation from one member state to another member state are free of customs duties and quantitative restrictions. This entitles the goods to move freely within the customs area without any restrictions. In contrast, goods which are imported from outside the customs area are subject to duties at the first point (country) of importation and once the goods have entered the customs area they cannot be subject to additional duties when imported by one member state from another member state.

²⁷ SACU is a customs union which was established in 1969 and its member states are Botswana, Lesotho, Namibia, South Africa and Swaziland. With South Africa gaining its democratic status in 1994, the member states renegotiated the 1969 agreement and in October 2002 the new Agreement (which remains in force today) was signed. The commonly used reference to the other member countries excluding South Africa is BLNS countries and this will be adopted in this Thesis

²⁸ Kirk, R. and Stern, M., "The New Southern African Customs Union Agreement" p.3 op.cit. The four other members of SACU apart from South Africa are usually referred to as BLNS countries

²⁹ The objectives of SACU include: - to promote the integration of members into the global economy; the facilitation of cross-border movement of goods between the members; to facilitate the equitable sharing of revenue from customs, excise and additional duties collected and paid into a common revenue 'pool'; to create effective, transparent and democratic institutions which will ensure equitable trade benefits to member states; to promote conditions of fair competition in the Common Customs Area; to substantially increase investment opportunities in the Common Customs Area; to enhance the economic development, diversification, industrialisation and competitiveness of member states; to promote the integration of member states into the global economy through enhanced trade and investment; and to facilitate the development of common policies and strategies – See *Article 2 of SACU Agreement, 2002*

The other important aspect of the customs area relates to the management of the Common Revenue Pool. All customs, excise and additional duties collected in the area are paid into the common revenue pool. The importance of these duties is to determine the revenue which accrues to Lesotho from the SACU revenue common pool. The mechanism and formula for the distribution and sharing of revenue³⁰ is set out in the Agreement. The revenue distribution mechanism was revised under the 2002 Agreement.³¹ In practice the revenue from the SACU pool has proved to be quite significant to the smaller member countries (Lesotho, Namibia and Swaziland).

The customs and excise taxes are important in the tax system of Lesotho since they determine Lesotho's share of revenue from the SACU pool. Therefore, it is important at the national level to record the information on the flow of goods accurately for that purpose. The government's share of the SACU receipts has continued to form a major contribution to its revenue.

The SACU member states have different economic backgrounds with South Africa dominating the economic market in this region. Though the SACU member states share a close economic and geographical relationship, the smaller member states have different economies from each other and South Africa. Amongst the smaller SACU member states, Lesotho remains one of the poorest countries in the world. As a result,

³⁰ For in depth discussion about SACU revenue sharing mechanism see Kirk, R., and Stern, M., "The New Southern African Customs Union Agreement" op.cit. p.9 and McCarthy, C., "The Southern African Customs Union in Transition" *African Affairs* 2003, 102 pp.605-630, DOI: 10.1093/afraf/adg082 p.624 - the basis of the formula is that total customs revenues which are collected from member states are distributed according to each country's share of total intra-SACU imports. This means that a country that imports most from within the union receives the largest share of the customs pool. The distribution of customs revenue does not take into consideration extra-SACU imports at all, but only intra-SACU imports. Extra-SACU imports refer to imports which originate from third countries (outside the SACU region). In practical terms, South Africa is the largest exporter within SACU. Therefore, this means that the BLNS countries import much more from South Africa and their share of revenue is higher compared to the share which South Africa is entitled to get.

The excise component is distributed on the basis of the "gross amount of duties which are levied and collected on goods produced in the common customs area." (McCarthy, p.625) In distributing funds from this component, consideration is given to an amount which goes toward funding of the SACU institutions and a further deduction is made to fund the development component of revenue allocations. The development component is intended to give smaller states members states (Lesotho, Namibia and Swaziland) some protection on the decline in the value of the revenue pool.

³¹ The formula in the 1969 Agreement was used to calculate revenue shares for the BLNS countries, with South Africa's share of the revenue determined as the residual after payments to the smaller member states have been determined.

Lesotho's economic and geographical situation has led to its reliance on South Africa particularly on the remittances from migrant workers who are employed in South African mines.

1.6 Conclusion

In this chapter it is argued that Lesotho's geographical situation raises challenging issues in relation to its economic and taxation policies. It is also acknowledged that Lesotho is restricted by its geographical situation in adopting its own economic and taxation policies. Furthermore, Lesotho's options towards its economic and taxation policies are also restricted by its obligations under the existing regional organisations such as CMA and SACU. Any policies which differ significantly from the neighbouring South Africa can result in problems such as smuggling of goods across the borders and avoidance of tax.

Despite the fact that Lesotho's options to improve its economic and taxation situation are restricted particularly by its geographical situation, lack of exploitable mineral resources, shortage of arable land for agricultural purposes, lack of viable big manufacturing industries, and retrenchment of miners from the South African mines, there are other areas which have the potential for revenue prospects. Lesotho's major resource is water and this need to be further regulated beyond the LHWP. For example measures to charge VAT on construction material for the project could be exploited. Furthermore, other types of tax could be introduced in this context, such as environmental taxes.

Like many other developing countries, Lesotho relies heavily on taxation to raise government revenue. However, with the existing economic situation it is impossible to actually implement the existing taxation policies effectively. Therefore, the introduction of VAT is seen as a turning point in taxation policy. With the decline of revenue from the SACU revenue pool, VAT is expected to perform very well in terms of revenue collection. The important questions are firstly, whether a VAT system can perform up to expectations within such an economic and geographical setting. Secondly, what is the

level of administration that can be expected to deal with the challenge to implement a VAT within such conditions? This leads to the question as to whether VAT is suitable for small developing countries. These questions are at the centre of the main themes of this thesis and are investigated further in the chapters which follow.

**PART 1: LESOTHO'S TAX SYSTEM AND AN OVERVIEW OF THE
STRUCTURE AND PRINCIPLES OF SALES TAX AND VALUE
ADDED TAX**

Chapter 2: Value Added Tax and Sales Taxes

“The nearly universal introduction of the value-added tax (VAT) should be considered the most important event in the evolution of tax structure in the last half of the 20th century.”³²

2.1 Introduction

In the last century a lot of countries, both developed and developing, have moved towards the introduction of VAT to replace their single-stage sales taxes and turnover taxes. The move to VAT has been for different reasons in each country. VAT was first introduced in developed countries³³ and was confined to a small proportion of countries until the late 1960s when it became the most popular form of tax on general consumption for governments.³⁴ Today VAT has spread over 120 countries covering nearly all parts of the World³⁵, with most countries in Europe, South America and Australia and the Pacific.³⁶ In 2001 there were 27 countries in Sub-Saharan Africa which had a VAT and by 2003 the number had gone up to 30.³⁷

This part of the thesis is intended to examine why countries have decided to move to VAT and what attracts them to a VAT system. The approach to this investigation is to examine the general principles of VAT, the structure and design of VAT, and reasons why most countries have moved to a VAT system. The analysis of the structure and principles of VAT makes reference to examples of approaches in the design of VAT systems in countries in Sub-Saharan Africa.

³² Cnossen, S., ‘Global Trends and Issues in Value Added Taxation’ *International Tax and Public Finance* Vol. 5 No.3 1998 pp.399-428 p.399

³³ France is the first country to introduce partial VAT in 1954 while Denmark is the first OECD country to introduce a comprehensive VAT in 1967, see OECD, *Taxing Consumption* 1988 pp. 27 and 79

³⁴ Owens, J., “The Move to VAT” *Intertax* 1996/2 pp.45-52 at p.45

³⁵ See Ebrill, L., Keen, M., Bodin, J. P., and Summers, V., *The Modern VAT* (IMF: Washington, D.C.) 2001 p.xiv

³⁶ See Table 2 for the statistics on the spread of VAT in different regions of the World up to 2001

³⁷ See Tables 2 and 3

Furthermore, the discussion also deals with the role of the IMF in the implementation of a VAT with particular focus in developing countries. The relevance of this part follows from the fact that in practice, it seems the IMF has played a leading role (particularly in developing countries) in undertaking studies which have recommended the introduction of VAT. This is true in the case of Lesotho as it is discussed in chapters 1 and 4. The other point of focus of this part is the comparison of VAT and sales taxes. The discussion examines why VAT is favoured over other sales taxes and the advantages and disadvantages of each type of tax is highlighted. The analysis and the discussions in this part are mainly theoretical and general, however emphasis is on relating such issues to the introduction and implementation of VAT in Lesotho. The methodology which is used in this part is mainly library based.

2.2 The International Monetary Fund (IMF) and Tax Reforms

2.2.1 The Role of IMF in the Implementation of a VAT

The IMF in particular (and the World Bank) has been in the forefront of tax reform activities in most countries particularly in developing and transition countries. The relevant question for this discussion is why the IMF has regarded the introduction of VAT as central to tax reforms and as part of its lending criteria?³⁸ It is therefore important to look at how tax reforms fit into the IMF's objectives.³⁹

³⁸ Tax reforms in developing countries usually come as part of the lending criteria of the IMF policy. The importance of the assistance by the IMF is to ensure that governments adopt initiatives and create conditions which are conducive in their countries to reach their macroeconomic targets and sustain their economic policies. Therefore, it can be argued that effective tax laws and policies are important towards achieving that goal.

³⁹ The IMF and the World Bank were established as financial institutions intended to supervise national exchange rates to ensure fair terms of international trade and to lend money on a short-term basis to member countries which faced balance-of-payments difficulties. The other important role of these institutions is to require information from member countries which deals with macroeconomic indicators (See Articles of Agreement of the International Monetary Fund, Article 1, www.imf.org) However, with the developments which have been achieved on fair trade at the international level, the first role of the IMF has ceased to exist but the other two roles have continued to expand and are at the centre of the IMF's role in tax reforms. The present discussion does not go into details of the nature and functions of

The tax reform activities of the IMF which are relevant for this study relate to providing technical assistance and education on tax law, policy and administration; and providing loans accompanied by conditions requiring tax reform.⁴⁰ The IMF does not seem to follow a specific approach to tax reforms in developing countries. It tends to adopt an approach which is suitable to the conditions which exist in each country. This point is emphasised by the following quotation; - “The macroeconomic conditions of each country, its social structure and priorities, its external debt situation, its administrative capabilities, and other relevant considerations are taken into account in developing tax recommendations best suited to that particular country.”⁴¹ However, the involvement of the IMF in tax reforms over a long period has led the organisation to develop guidelines towards effective tax reforms. These guidelines tend to underlie its recommendations on this subject.

The main elements of the IMF reform policy include: the introduction of a broad-based VAT (to replace sales taxes and turnover taxes); tax administration reform; revenue efficiency initiatives and general tax law and policy reforms. These elements are discussed below:-

(1) Tax law reform and the introduction of VAT: - The IMF supports the introduction of VAT as the main component of tax reforms to replace the predecessor sales taxes and turnover taxes. The reason why the IMF has placed emphasis on the introduction of VAT is that VAT is regarded to have the potential to contribute towards the creation of a stable and efficient macroeconomic policy and to increase tax revenues for the countries concerned. The other reason why the IMF favours VAT is that the tax seems to have a long term potential to raise more revenue for the government. In that way, this could lead to reduce the dependence of countries on loans and aid.⁴²

both the IMF and the World Bank; reference is made only to their role in tax reforms relating to the introduction of VAT

⁴⁰ Stewart, M., and Jogarajan, S., “The International Monetary Fund and Tax Reform” *British Tax Review* 2004 No.2 p.147

⁴¹ Tanzi, V., “The IMF and Tax Reform” chapter 12 p.445 in *Tax Policy and Planning in Developing Countries* ed. By Bagchi, A. and Stern, N., 1994 (Oxford University Press: Delhi)

⁴² In accordance with the IMF’s recommendation to introduce VAT for those countries that did not have a VAT, this was their main activity of their proposed tax reforms and part of their loan conditions. For example the following countries in Sub-Saharan Africa prior to 2000 were affected: Botswana, Central

It seems the arguments to favour VAT are mainly based on the features of this tax particularly the fact that VAT is a multi-stage tax, its invoice based mechanism has an in-built mechanism to trace transactions through the trail of invoices, and the fact that it relies on the self-assessment principle. It appears that this principle strengthens compliance by business entities, while it is also an advantage for the administration. In practice the principle of self-assessment is also introduced to other taxes such as income tax as it is the case in Lesotho, South Africa and UK. Therefore, it can be argued that VAT has had a positive impact on the approach towards compliance in relation to all taxes by registered taxpayers.

The IMF's proposal in regard to a VAT system is that the tax should preferably be introduced at a single rate of close to 20 per cent so that the coverage of the tax is also increased.⁴³ (See Table 1 for the standard VAT rates in Sub-Saharan Africa). Similarly, the World Bank supports the introduction of VAT at a rate of about 20 per cent as part of the tax reforms and this is clearly expressed in this way: - "to introduce or strengthen a broad based consumption tax, notably a VAT, preferably with a single rate (generally in the range of 15-20 per cent) and minimal exemptions, with excise taxes levied at ad valorem rates and restricted to a limited list of products...and equally applied to imports as well as domestic products".⁴⁴ In Table 1, I show the various VAT rates (standard rates) which were adopted when VAT was first introduced in countries in Sub-Saharan Africa.

African Republic, Chad, Ethiopia, Guinea Bissau, Mozambique, Namibia, Lesotho and Swaziland. Evidence that this was more a conditionality rather than a recommendation can be seen in Ethiopia's Letter of Intent where the IMF states 'the government will take all necessary steps to introduce a VAT in January, 2003' – International Monetary Fund, Ethiopia Letter of Intent, *Memorandum on Economic and Financial Policies and Technical Memorandum of Understanding*, 29 January 2001

⁴³ Stewart, M. and Jogarajan, S., "The International Monetary Fund and Tax Reform" p.152 see note 35 J. Stotsky, "Summary of the IMF Tax Policy Advice" in Shome, P., (ed.) *Tax Policy Handbook* 1995 (FAD: IMF) p.279

⁴⁴ World Bank, *Lessons of Tax Reform* 1991 p.10

Table 1 – Standard VAT rates in Sub-Saharan Africa (List include only countries with a VAT)

Country	Standard rate	Date
Benin	18%	1991
Botswana	10%	2000
Burkina Faso	18%	1992
Cameroon	18.7%	1999
Central African Republic	18%	2001
Chad	18%	2000
Congo, Republic	18.9%	1997
Cote d'Ivoire	20%	1960
Equatorial Guinea	17.5%	1999
Ethiopia	15%	2003
Gabon	18%	1995
Ghana	12.5%	1999
Guinea	18%	1996
Guinea Bissau	15%	2001
Kenya	16%	1990
Lesotho	14%	2003
Mali	18%	1991
Mauritania	14%	1995
Mozambique	17%	1999
Namibia	15%	2000
Niger	17%	1986
Nigeria	5%	1994
Senegal	18%	1961
South Africa	14%	1991
Sudan	10%	2000

Swaziland	14%	2003
Tanzania	20%	1998
Togo	18%	1995
Uganda	17%	1996
Zambia	17.5%	1995

*Source: Riswold, S., "Value Added Tax in Sub-Saharan Africa: A Critique of IMF VAT Policy" *Intertax* August/September 2004 Vol.32 pp427-444 at p.428 (some countries which were included in the original table from the source which have not adopted a VAT, are left out in this table since they are not relevant for purposes of the present discussion.)

The various standard VAT rates in these countries represent the kind of rate which the IMF recommends for the implementation of the tax, though some of the rates are slightly lower than what is recommended. The statistics also indicates that VAT in most countries is implemented at higher rates than sales taxes and this point is reflected when the comparison of the two taxes is discussed at paragraph 2.7.

The other significant point which can be highlighted from the statistics is the date when the different countries adopted a VAT. It seems that most of these countries adopted a VAT in the 1990s; one country in 1986; two countries in the 1960s and some countries after 2000 and onwards. The countries which adopted VAT in the 1960s are Cote d'Ivoire and Senegal and this seems to follow from the fact that these two countries were French colonies and therefore, they were highly influenced by the introduction of VAT in France (as the first country to introduce partial VAT).

It is clear from this discussion that the IMF is behind the view that countries should adopt a VAT in place of sales taxes and turnover taxes. This is also indicated by the volume of research and studies the IMF has undertaken in relation to VAT and tax reforms in developing countries⁴⁵ (some of these publications are used as reference material in this thesis).

However on the other hand, the IMF VAT policy in developing countries has not gone without criticism, especially with respect to countries in Sub-Saharan Africa. This policy is criticised for being unsuitable for developing economies as a result of the

nature of such economies. For example, it is acknowledged that ‘VAT can be administered at most levels of economic development but as a broadly based transactions tax it is particularly suitable for large, integrated economies with sophisticated production and distribution process’.⁴⁶ This can be correctly interpreted as saying that VAT is not suitable for developing economies. Similarly, Shoup concludes that ‘VAT is not ideal for all developing countries’.⁴⁷

In practice, despite the different views which exist on whether VAT is suitable in developing countries, the position indicates a wide spread implementation of VAT in these countries particularly in Sub-Saharan Africa (see Table 2 for the spread of VAT up to 2001). This issue is also highlighted by examining the implementation of VAT and its administration in Lesotho. The case of Lesotho is used in this Thesis as an example of implementing a VAT in a small developing country.

Table 2 – Spread of VAT by 2001

Countries by region	1969	1979	1989	2001
Americas	2	12	17	27
Asia & Pacific	0	1	6	22
European Union	5	12	15	17
Eastern Europe/CIS	0	0	1	25
NorthAfrica&MiddleEast	0	1	5	6
Sub-Saharan Africa	1	1	4	27

Source: Ebrill, L., Keen, M., Bodin, JP., and Summers, V., *The Modern VAT* op.cit. p.6

⁴⁵ The IMF staff has published extensive material on ‘Tax reforms in developing countries’ and on VAT in developing countries – see the IMF website for the relevant publications, www.imf.org

⁴⁶ Cnossen, S., “Design of the Value Added Tax: Lessons from Experience” in J. Khalilzadeh-Shirazi and A. Shah, *Tax Policy in Developing Countries* (The World Bank) 1991, p.72 at p.84 quoted in Riswold, S., “Value Added Tax in Sub-Saharan Africa: A Critique of IMF VAT Policy” op.cit. p. 443

⁴⁷ Shoup, C., “The Value Added Tax in Developing Countries” *World Bank Research Observer* 1988 Vol.3 No.2 p.150 quoted in Riswold, S., op.cit. p.443 – Shoup lists factors which tend to affect the suitability of a VAT as: those countries where foreign trade plays a minor role, small scale agriculture is important, retail trade is fragmented among very small traders, discrimination among investment goods is not considered harmful, basic accounting is not widespread, and efficient and impartial administration has not been achieved.

Table 2 represents the spread of a VAT in the different regions over a period of 4 years. It is important to note that the spread of VAT in Sub-Saharan Africa seems to have taken place in a number of countries after the 1990s. This could indicate the period when the IMF began its tax law reform policy which focused on the introduction of VAT in developing countries. Furthermore, this could be attributed to the introduction of the Structural Adjustment Facility (SAF) in 1986 and the Enhanced Structural Adjustment Facility (ESAF) in 1999 (which was renamed the Poverty Reduction and Growth Facility (PRGF) in 1999).⁴⁸ Most of the developing countries in Sub-Saharan Africa during the late 1980s and early 1990s were provided with loans under the schemes and had to engage in tax reform as a condition of such loans.

Furthermore, the Table shows that VAT was introduced by most countries particularly in the European Union and the Americas in late 1970s and in 1980s. Though there are huge differences between the economies of countries in these regions, the important issue is how the tax performed. The diversity and spread of the introduction of VAT can be regarded as an indication of acceptance and willingness to adopt a VAT.

In most of these countries VAT is seen as the modern tool towards a stable and efficient tax policy. None of these countries have so far decided to abandon VAT and replace it with another type of consumption tax. Therefore the conclusion which can be drawn is that despite the criticisms which are made towards the implementation of VAT in developing countries and despite the problems which can affect its implementation, it has not resulted in total failure as a tax.⁴⁹

It can also be argued that individual countries have a choice to design the features of a VAT to suit the existing economic and social conditions. The features of a VAT which are not suitable in each country can be redesigned accordingly. However, the government should pay attention to the fact that the nature and principles of the tax are not affected by redesigning the features. The important goal for developing countries

⁴⁸ Stewart, M., and Jogarajan, S., "The International Monetary Fund and Tax Reform" op.cit. p.149 - These facilities were associated with IMF's condition of lending and aimed at providing concessional lending to low-income developing countries.

⁴⁹ The in-depth discussion of this issue is beyond the theme of this research as the focus in this study is on the introduction of VAT in Lesotho, though a few examples are drawn from other countries for purposes of illustration only, without necessarily studying the VAT systems in those countries in details.

is to design a simple but efficient tax system which is easy to administer and to comply with, while at the same time preserving and maintaining its broad base feature.

(2) Tax administration reform: - As far as tax administration is concerned the IMF's view has been that "tax administration plays a crucial role in determining a country's real (or effective) tax system."⁵⁰ The IMF has prioritised the practical tasks of tax administration from registration and returns processing (with computerisation) to collection, auditing and enforcement. It further identified measures which can help to improve efficiency of tax administration to include: the goal of voluntary compliance; self-assessment; taxpayer education (focusing on the taxpayers' obligations); prompt detection of problems with filing and paying; improvement of audit coverage; and adequate penalties.⁵¹ In practice countries would need to expand on these measures (depending on their specific needs) to achieve effectiveness of the system. The other determining factor as to what measures are adopted to improve the efficiency of the VAT system would depend on the resources which are available to the administration.

In practice the introduction of VAT is also associated with the reform of tax administration which extends to other types of tax such as income tax and customs and excise duties. This has been the case in Lesotho where the introduction of VAT was also part of tax administration reforms in general, in the sense that a national revenue authority was established to strengthen tax administration and also had the task to introduce VAT. Similarly, this has also been the position in some of the developing countries, that VAT has been used to improve the collection of other taxes and to improve the administrative strategies and institutions on revenue collection. For example, in Sub-Saharan Africa the introduction of VAT formed part of the general reforms of revenue administration mechanisms. This was seen in South Africa in 1991 when the South African Revenue Services (SARS) was established as an initiative to improve revenue collection and administration. This was followed by the introduction of VAT. In the same way, Zambia adopted the same approach in 1995 with the

⁵⁰ Tanzi, V. and Pellechio, A., "The Reform of Tax Administration" *IMF Working Paper* 1995 No.22 quoted in Stewart, M. and Jogarajan, S., "The International Monetary Fund and Tax Reform" op.cit. p.157 note 57

⁵¹ Stewart, M., and Jogarajan, S., "The International Monetary and Tax Reform" op.cit. p.158

establishment of the Zambian Revenue Authority (ZRA) and the subsequent introduction of VAT. Similar practice was adopted in Tanzania and Uganda in 1996 and where the establishment of both the Tanzania Revenue Authority (TRA) and the Uganda Revenue Authority (UGA) were followed by the introduction of a VAT.

(3) The revenue imperative: - It seems the key goal of most IMF-related tax reforms is to increase tax revenues within a country. The tax component of fiscal reform has centred on VAT as having 'the primary revenue-raising role' of tax systems.⁵² The view is based on the fact that it is possible for a VAT to have a broader base than other sales taxes and this has the potential to raise more revenue. In contrast the World Bank is opposed to tax reform that will mainly concentrate on increasing revenue. It argues⁵³ "that additional tax revenues will go into the leaders' pockets, that government spending is inefficient and stifles private incentives, or that a smaller state is better for economic growth, hence cutting expenditures is better".

In practice the revenue efficiency component of VAT is one of the reasons why it has been introduced in many countries. VAT is viewed as an efficient indirect tax in terms of bringing more revenue to the government 'pool'. This has been supported mainly by the IMF staff and the World Bank and even many economists hold the same view. The World Bank has noted that VAT's 'revenue raising potential, even at moderately low rates, has proven to be substantial, even for countries at early stages of development'.⁵⁴ The following countries are examples of where this has been the case, Indonesia, Korea, New Zealand, Portugal and Tunisia. However it is also acknowledged that in some countries this was not the case.⁵⁵

⁵² George, A., et al, "IMF Fiscal Reforms in Low Income Countries: Experience Under IMF-Supported Programs *Occasional Paper*, IMF 1988 p.1 at p.10 quoted in Riswold, S., "Value Added Tax in Sub-Saharan Africa: A Critique of IMF VAT Policy" op.cit. p.430 note 8

⁵³ Stewart, M., and Jogarajan, S., "The International Monetary Fund and Tax Reform" op.cit. p.154 note 38

⁵⁴ World Bank, *Lessons for Tax Reform* op.cit p.10

⁵⁵ For example it appears that Kenya and the Philippines experienced an initial revenue shortfall after introduction of VAT (World Bank, *Lessons for Tax Reform*, op.cit p.10). It seems that in these two cases, this initial revenue shortfall can partly be attributed to the fact that the governments did not devote sufficient time for the introduction of VAT (see Tait, A.A., *Value Added Tax: Administrative and Policy Issues*, *Occasional Paper* 88 1991 p.1. This means the administration did not have enough time to prepare for the implementation of the tax.

Despite this experience of revenue decline in some countries, the IMF seems to maintain the position that “the VAT provides a new, buoyant revenue base, typically yielding more than initial estimates....”⁵⁶ However it is acknowledged that this is not automatic nor does it happen over a short period of time.

2.2.2 Conclusion on the Role of IMF in Implementing VAT

The most important motivation for developing countries’ tax reform is the need to raise more revenue-resource mobilization.⁵⁷ With the IMF and the World Bank in the forefront of the fiscal tax reforms in developing countries, these countries are not left with much choice but to introduce VAT rather than other types of indirect taxes. This move finds support from some economists who note that, “the VAT should be an instrument of choice for most developing countries contemplating reform of their sales tax”.⁵⁸ As it appears from the discussion, tax reforms in most countries have centred on the introduction of VAT and strengthening of tax administration. This demonstrates a direct result of the IMF and the World Bank influence.

2.3 The Move to VAT: Why Would Countries Move to a VAT?

A number of countries have recently adopted a VAT to replace their single stage sales taxes and selective taxes. There are various reasons why these countries have chosen VAT to replace their predecessor indirect taxes and this differs from country to country. This part examines why a number of countries have adopted VAT in place of various other taxes. This point is discussed with the use of examples from developing countries to illustrate some of the reasons why these countries have adopted a VAT.

⁵⁶ Tait, A.A., *Value Added Tax: Administrative and Policy Issues*, op.cit, p.1

⁵⁷ Virmani, A., “Tax Reform in Developing Countries: Issues, Policies, and Information Gaps” *Public Finance* 1988 No.1 pp.19-38 at p.19

⁵⁸ Khalilzadeh-Shirazi J. and Shah, A., “Tax Reform in Developing Countries: Introduction and Overview” p.xvii-xix J.

In practice it seems a country is prompted to introduce VAT for one or more of the following reasons:-

The first point is that a country may not be happy with the economic efficiency of the existing taxes. Economic efficiency in this context includes revenue efficiency, administrative efficiency, allocation and distribution of the taxation burden, and the failure by the tax to contribute towards the stability of the economy and to achieve neutrality in the tax system.⁵⁹ The components of revenue and administrative efficiency are discussed separately to examine how they could have been affected by the taxes which VAT has replaced. In most countries it appears that the taxes which are replaced by VAT failed to achieve any one or all of the components of economic efficiency.

Thus it appears that some countries particularly in Africa moved to VAT because they were not happy with their single stage sales taxes (for example, retail sales tax, wholesale and manufacturers' sales taxes) for two reasons. Firstly, these taxes were criticised for failing to contribute to the stability of the economy and failing to achieve distribution of the burden of taxation.⁶⁰ In practice single stage sales taxes tend to be more vulnerable to fraud, since revenue is collected at one stage of the production and distribution chain. This means in cases of fraud, there is a risk that all revenue can be lost and this will affect the revenue efficiency of the tax.

The second reason why some countries were not happy with the single stage sales taxes is that these taxes failed to achieve administrative efficiency. For example it appears that Tanzania's move to VAT in 1998 from sales tax resulted from the administration problems which undermined the efficiency of the tax.⁶¹ It appeared that the tax administration in that country could not effectively enforce compliance of the tax, therefore, VAT was considered to be an option since it has the mechanism of self-assessment and that in a way ensures some form of compliance by the business entities.

⁵⁹ Cnossen, S., "Issues in Adopting and Designing a Value-Added Tax" in Sandford, C., *Key Issues in Tax Reform* (Fiscal Publications:Bath) 1993 at pp.73-105 at p.74

⁶⁰ Sandford, C., *Why Tax Systems Differ: A Comparative study of the Political Economy of Taxation* 2000 (Fiscal Publications: Bath) p.80

⁶¹ Due, J., "Two new African added taxes, Tanzania and Mozambique" *International VAT Monitor* 1999 Vol.10 Part 3 pp.117-123 at p.118

The second point which can influence a country to adopt a VAT relates to the pressure and the need to raise more revenue for the government. It appears that a lot of countries (both developed and developing) have adopted a VAT because it is “an exceptionally stable and flexible source of government revenue”.⁶² In practice some countries adopted VAT mainly for its potential to raise more revenue than its predecessor taxes.⁶³ For example, reference can be made to the adoption of VAT in Kenya in 1990 which was motivated by “the favourable revenue potential, economic efficiency and administrative features of the VAT”.⁶⁴ Furthermore, the position in developed countries does not seem to be any different, as the move to VAT was amongst other reasons favoured for its potential to raise more revenue. For example some of the OECD countries like Norway and New Zealand decided to move to VAT to increase their revenues from general consumption tax “in order to be able to cut their income tax”⁶⁵ or “to reduce their relative reliance on it” as it was the case in Denmark and Turkey.⁶⁶ In practice it seems that the issue of whether VAT has the potential to raise more revenue than its predecessor taxes is not very well established.

The third point is that customs union arrangements and agreements can also influence countries to move to a VAT. A customs union requires discriminatory border taxes to be abolished and the adoption of uniform and common tax systems, particularly a VAT system. For example this was the case in the European Economic Community (now the European Union) where member states adopted “the common VAT system as a way to find a mutually acceptable method of indirect taxation which would operate without producing distortions in the flows of trade among the members of the economic union.”⁶⁷ Therefore it became a requirement for countries applying for membership of the Community to introduce VAT.

⁶² Cnossen, S., “Issues in Adopting and Designing a Value-Added Tax” op.cit. p.74

⁶³ This point that a VAT has potential to raise more revenue than its predecessor taxes lies in its features as a multi-stage tax which are discussed below at paragraph 2.4

⁶⁴ Glenday, G., “On Safari in Kenya: From Sales Tax to Value Added Tax” *International VAT Monitor* 1991 Vol.12 pp.2-6 at p.3

⁶⁵ OECD, *Taxing Consumption* op.cit p.27

⁶⁶ Ibid

⁶⁷ See *Value Added Tax*, a report by NEDO op.cit. p.3

Similarly, SACU member states have also moved towards the implementation of VAT in the individual states, though there has not yet been a move towards the adoption of a common VAT system. However, it can be expected that with closer cooperation in other areas within the customs union, there is likelihood that in future the member states will extend cooperation towards the adoption of a common VAT system.

The fourth point which can also influence a country to adopt a VAT is where the neighbouring countries or trading partner(s) have adopted a VAT. This can be true in practice particularly if the neighbouring country or countries and trading partners have large and stable economies. For example, it seems that the introduction of VAT in Mozambique in 1999 was influenced by “the use of a VAT in South Africa which was its major trading partner and also by the introduction of value added taxes in other African countries.”⁶⁸ Where that is the case, it can be argued it is likely that the country which is adopting a VAT will try to design the structure of its VAT system to be similar to VAT of its trading partners or neighbouring countries. The reasons which influenced Lesotho specifically to move to a VAT system are discussed at paragraph 2.8.

2.4 General Principles and Basic Design of VAT

VAT is defined as a tax charged on consumption which relates to goods and services. The following definition by Tait⁶⁹ is used in this study, “VAT is a tax on domestic consumption in the private sector of the economy, but leaving out some services which are difficult to tax; those which are regarded as basic to the social needs and which cannot readily be ascribed to the transaction”. This definition emphasizes the attributes of a VAT as; - (1) a tax; (2) levied on domestic consumption; (3) the consumption should be in the private sector as opposed to the public sector; (4) some services and goods are exempted (this includes some services and goods which are administratively difficult to tax and those which for social considerations are left out of the tax net and some of those which are regarded as essential are zero-rated). The character of the tax should therefore result in taxation not only of the consumption of goods by private

⁶⁸ See Due, J. F., “Two new African Value Added Taxes - Tanzania and Mozambique” op.cit. p.120

⁶⁹ Tait, A.A., *Value- Added Tax* 1972 (IMF: Washington, D.C.) p.19

persons, but also in taxation of the use of machines, means of transportation and other means of production.⁷⁰

VAT is charged on all goods and services which are for final consumption while at the same time it leaves out all intermediate goods. VAT can therefore be described as a method of taxing by instalments final consumer spending in the domestic economy. In this sense VAT does not impose any tax liability on exports, it only taxes imports which are intended for consumption within the domestic jurisdiction where it is destination based. Furthermore, VAT is charged at the final stage of production and distribution which concerns either the consumer or an unregistered business entity that purchases goods for their own consumption. The question which arises is, why does VAT tax only domestic consumption? VAT taxes only domestic consumption to ensure that the goods or services are only taxed when they are imported or purchased from domestic suppliers with the possibility to recover input tax unless they are purchased by the final consumer. The idea of domestic consumption ensures that VAT is a tax on consumer spending and not on intermediate transactions.

The features of VAT may differ from country to country and be designed to suit the circumstances of each country. The discussion which follows examines the key characteristics of the tax as widely implemented by different countries. The first feature of VAT is that it is a multi-stage type of tax. This means it is a broad-based tax levied at each stage of production. The advantage of this system is that revenue should be secure as it is collected throughout the entire process of production. Therefore, if revenue has been lost (through fraud or avoidance measures) at one stage, there is a possibility to collect revenue at the next stage of production. There is less risk of losing all the revenue during this process. On the other hand, this system has a disadvantage of costs which are attached to administration and policing of the system throughout all the stages to ensure that revenue is collected accordingly.

⁷⁰ See Terra, B., *Sales Taxation: The Case of Value Added Tax in the European Community* 1988 (Kluwer Law and Taxation Publishers: Norwell) pp.5-6

Furthermore, the multi-stage feature of VAT ensures that the tax is charged at all stages of production with the provision of some mechanism enabling business entities to offset the tax they have paid on their own purchases of goods and services against the tax they charge on their sales of goods and services.⁷¹ This mechanism entitles the business entities to recover their input tax which they have incurred previously against the output tax which is finally charged on the item. In this way this means that VAT can be reclaimed in the next link in the trading chain until the final consumer is reached; and it is argued that this feature indicates that, “all traders are treated on an equal footing.”⁷² The effect of this mechanism is that the final consumer pays only the exact amount of the input VAT at the last stage of production and is not entitled to claim a refund of the VAT incurred. This point is emphasized in the following way: “VAT ensures that the ultimate tax aggregate on every article sold or service rendered to a consumer is always the rate prescribed for the article or service in question.”⁷³ It is only at the last stage of production that the VAT which has been charged does not give rise to any credit or repayment. The effect of the tax at this stage is that the final consumer or an unregistered business entity is not entitled to claim any credit for the VAT which they pay at the final stage of production. The rationale is that this is the stage where final domestic consumption takes place and tax is accordingly charged and incurred.

This feature of VAT can be illustrated with the following example:- Suppose that firm 1 sells leather material for a price of £100 (excluding tax) to firm 2, which in turn sells its leather products for £400 (excluding tax) to final consumers. These 2 firms have established their firms in country X which has an existing VAT at 10 per cent and the firms are therefore obliged to charge VAT on their sales. Firm 1 will then charge firm 2 £110, paying £10 to the Revenue office in tax. Firm 2 will then charge final consumers £440, paying tax of £30 to the Revenue office: output tax of £40 less a credit of £10 of tax charged on its inputs. The Revenue office collects a total of £40 in revenue. This

⁷¹ Ibid

⁷² See Owens, J., “The Move to VAT”, op.cit. p.45

⁷³ Knatz, T., “Value Added Tax: Practice and Planning” *British Tax Review* 1970 p.292

type of transaction indicates that the tax is collected at every stage of production and the tax is not suspended until the final stage which is on the sale to the final consumer.

The multi-stage feature of VAT implies that two elements are essential to ensure that tax is levied only on consumption. These are firstly, that at each stage, net tax must be payable only on the difference between sales and purchases (in effect eliminating tax on inputs); and secondly, that there must be no breaks in the VAT chain. VAT is intended to be charged and collected in instalments at each stage in the production and distribution stage where value is added. The fact that VAT is charged only on the difference between sales and purchases at each stage ensures that tax is not charged on the capital or the original value of the goods, to avoid levying tax on items which have already been taxed (tax on tax).

The nature of VAT as a tax on consumption and as a multi-stage tax is expressed by Wilmott in the following way:-“VAT is nominally a tax on value added. However, governments regard its real purpose as to tax final consumption and the tax collected in instalments at each stage in the distribution process where value is added “rolls forward” to the final purchaser (who cannot deduct it) and is equal in its sum to the product of the value of the final sale and the tax rate to which it is liable. Hence the taxation of value added becomes a mere mechanism for collecting the tax rather than the underlying goal of the tax.”⁷⁴

The second feature of VAT relates to the use of Zero-rating and Exemption. Zero-rating applies where the rate of tax charged to sales is zero but credit is given for taxes paid on inputs. This means the zero-rated business entity is entitled to a full refund of taxes paid on inputs. In actual fact the business entity is liable to an actual rate of VAT, which happens to be zero. Therefore, this makes a zero-rated business entity a part of the VAT system. The business entity is liable for registration and to make a full return for VAT in the normal way. The business entity is also liable for any administrative and

⁷⁴ Wilmott, P., “A Common VAT System for the European Union” 1997 *E.C. Tax Journal*, Vol.2 p.7 in Butler, D., “VAT as a Tax on Consumption: Some Thoughts on the Recent Judgment in *Parker Hale Ltd v. Customs and Excise Commissioners*” *British Tax Review* 2000 No.5 p.545-553 at p.551 note 20

compliance costs which arise. However when this business entity applies the tax rate to its sales, it ends up as a zero VAT liability. Though the trader's liability is zero, he is entitled to deduct the VAT liability on his inputs and is entitled to a repayment or refund of tax from the government. The consequence of this legal outcome "means that there are a number of business sectors, which are permanently in a 'net repayment' position. That is, instead of paying the government tax when they submit their VAT returns, the government has to refund their input VAT."⁷⁵ The rationale behind zero-rating is to avoid extending the scope of VAT to include certain essential goods and services.⁷⁶

In practice most countries zero-rate exports (including other international supplies) and allow zero-rating of domestic supplies of certain goods. Zero-rating of exports and other international supplies follows from the destination principle of VAT, which requires that exports should be tax free when they leave the jurisdiction of a country and be accordingly taxed upon importation to another country.

Zero-rating of domestic supplies is justified on the grounds of social necessity to relieve the burden of taxation from a particular group of the society, which is generally the low income earning group. The rationale for this justification is that there are goods that are so essential for public use that they deserve to be excluded from tax in order to mitigate the impact of VAT on the poor members of the society. For example such goods can include basic food products and agricultural products. However in practice this has proved to be controversial as to whether zero-rating of food for example benefits the low income earners or the rich and whether it is a good approach to mitigate the burden of tax on the low income earners. For example, it was found that "in Ireland although the poor spend relatively more of their income on food, the rich spend twice as much in absolute amounts as the poor, because they buy more expensive varieties, eat out more often and tend to throw food away more easily."⁷⁷ The result in practice was that zero rating of food in Ireland, therefore benefits twice as much the high income earning group as compared to the low income earning group.

⁷⁵ Knatz, T., "Value Added Tax: Practice and Planning" op.cit. p.292

⁷⁶ Ogley, A., *Principles of Value Added Tax: A European Perspective* 1988 (Interfisc: London) p.12

⁷⁷ Cnossen, S., "Global Trends and Issues in Value Added Taxation" op.cit. pp. 409-410

Examples of countries which have a zero-rate on internal supplies like food are the UK, Ireland, and most developing countries such as South Africa, Lesotho, Kenya and Zambia. In practice most governments employ taxation issues as one of their campaigning strategies to be elected or stay in power. Therefore, governments feel that they have both a political and social duty to ensure that the burden of taxation is fairly distributed amongst the different sectors of the society. One of the ways to ensure that the government keep their voters, particularly the low income earners, is by the use of zero-rating to relief tax from some basic necessities and goods. It can be argued that in such circumstances zero-rating is used mainly for political reasons and not necessarily for economic reasons.

Though the use of zero-rating seems to be intended to benefit the disadvantaged groups of society, there are a number of problems which arise from the use of zero-rating which can be highlighted. The main problem which results from zero-rating is the issue of refunds of tax to the business entity. The difficulty arises where the business entity deals with both zero-rated and standard rated goods. The administration has to pay attention to the fact that refunds are claimed only in relation to the zero-rated goods, while the other category of goods is taxable, though the trader has the right to claim tax on inputs in relation to them. Therefore, the administration has to ensure that the refunds which are claimed are towards the zero-rated items and there are no fraudulent or fictitious claims and invoices which are made by the business entity.

The other problem which can result from zero-rating is that it is likely to result in high numbers of voluntary registrants for VAT. Business entities can be attracted to the VAT system by the fact that they are able to obtain refunds from zero-rated items. The problem with extending the number of voluntary registrants is that it increases the burden on the administration and stretches the administration costs too.

Zero-rating is also known as exemption with credit in some jurisdictions.⁷⁸ Exemption with credit applies to exports of goods and services where the recovery of input VAT is permitted. The rationale behind this mechanism is to ensure that all VAT

⁷⁸ The concept of exemption with credit is commonly known within the EU member states

which was previously incurred in the production or distribution chain is remitted to the supplier when the goods are exported. Exemption with credit and zero-rating have got the same effect as they both allow the recovery of input tax and it can be assumed that both traders who deal in zero-rated goods and exporters of goods and services are required to register for VAT even though they are not obliged to pay VAT to the government. In this way, some writers provide “that zero-rating may also be described as ‘exemption with credit’”.⁷⁹

Furthermore, zero-rating can also be contrasted with exemption. Exemption is a concept which applies where tax is not charged on outputs, but tax on inputs cannot be reclaimed. The effect of exemption is that it does not provide complete relief from tax in the sense that tax on intermediate transactions remains unrecovered therefore, the business entity that is making an exempt supply would have had to pay VAT on the value of the supply or part of it.

A business entity which is exempt from paying tax is not required or permitted to charge VAT on its outputs. In the same way it is not permitted to recover the input VAT which it has incurred unlike the case with a business entity which deals with zero-rated items. It is for this particular reason that the business entity will have to pass some of the VAT to the buyer included as part of the price in a taxable supply. In most countries exemption applies to financial services, education services, and other public sector activities, for example, transportation services and quasi-governmental activities. Exemption may also relate to the exclusion of small traders from the VAT system through the use of a registration threshold (this means setting a registration threshold which will exclude small traders).

The effect of the exemption principle is to relieve the exempt sector from the scope of tax but denying such a sector the right to recover input VAT which has been previously charged. To the extent that exempt inputs are used in the production or distribution chain, this has the effect of turning VAT into a cascade tax (charging tax on products which already bear tax). Consequently, a business which uses inputs, such as

⁷⁹ Williams, D., “Value-Added Tax” in Thuronyi, V., *Tax Law Design and Drafting* 1988 Vol.2 (IMF: Washington D.C.) pp.164-229 at p.203

financial services which have incurred input VAT which cannot be recovered and recharged in the usual way, will have to adjust its prices accordingly.⁸⁰

An exempt entity is not required to register with tax authorities and does not become part of the VAT system. Therefore, an exempt business entity does not charge VAT on its sales.

Exemption can be justified on a number of grounds: - first, there are exemptions that may be designed to improve, rightly or wrongly, the progressivity of the VAT;⁸¹ second some exemptions are justified on grounds of social policy. The justification is that some goods and services are provided for social reasons and in the interest of the public. These include those types of supplies which are made directly to consumers and constitute supplies of a social nature. These include medical supplies by public hospitals and private hospitals and private doctors; and education. These kinds of supplies in some countries are not made in return for payment, particularly where they are provided by a state entity or subsidiary state entity and are subsidised. This is the case in countries which offer free medical and health services and education services. However, the exemption extends even to the same services when they are provided by the private sector.

Third, some goods and services are exempted because they are regarded as difficult to tax and governments find it administratively easier not to tax them. Examples of services which are widely exempted are public transportation, financial services, educational services, medical services and the provision of water. However, though these services are exempt, the service providers pay tax on all their inputs in acquiring their goods and services such as office equipment, stationery, computers, and use of electricity. These sectors are not permitted to claim refunds of the tax which they have paid.

⁸⁰ Ogley, A., *Principles of Value Added Tax: A European Perspective*, op.cit. p.9

⁸¹ Bickley, J.M., *Value Added Tax: Concepts, Policy Issues and OECD Experiences* 2003 (Novinka Books: New York) p.6

The exemption of financial services can be used to illustrate the administrative difficulty which has led to the exemption of this sector. The difficulty relates to identifying and taxing some components of value added on each service provided by these institutions. In practice most countries have not integrated the taxation of financial services into their VAT system because they regard them as administratively difficult to include in the tax net.⁸² Financial services in the form of banks and other financial intermediaries render services to both depositors and borrowers. Attached to the provision of these services are fees charged by such institutions which may either be implicit or explicit. They are implicit if they are already in-built in the service provided. For example, in transactions involving foreign currency exchange, financial institutions often buy the currency at a slightly lower rate than the one they are prepared to sell for. They may also charge or not charge the commission on the transactions effected. The fact that a commission has not been charged by the bank does not mean that no consideration is given. The rates at which the institutions are prepared to sell or purchase currencies are different and are spread accordingly. In return for the services provided, the institution will include a consideration in the calculation and keep that for itself.

The explicit charges on the other hand include Automated Cash Machines charges (or what are called cash lines in some countries), cheque-book fees and handling fees related to facilities and services they provide. These charges may be taxable, unlike implicit charges. This means these institutions can be able to deduct input tax on purchases and expenditure attributable to taxable services and similarly the business users of these services can deduct VAT charged on such services.

Apart from offering these services, financial institutions also provide other services such as financial and investment advice, asset management and a variety of insurance services. It seems that the difficulties attached to the taxing of these services result from the definition of financial services; the measurement of the taxable component which relates to measuring inputs and outputs in this case and identifying the

⁸² For a full discussion of the Treatment of Financial Services under a VAT, reference is made to Schenck, A, and Howell, H.Z., in *Tax Notes International* 25 June 2001 p.3309 "Treating Financial Services under a Value Added Tax: Conceptual Issues and Country Practices" and Ebrill, et al., *The Modern VAT* op.cit.

person who is liable for the tax.⁸³ It seems it can be concluded that the problems which are attached to including financial services in the tax net are both administrative and technical.

The exemption of some services can result from both political and economic reasons. For example, apart from being regarded as administratively difficult to tax, the exemption of financial institutions can be used as a marketing tool for investment within a country. In this case foreign investors can be attracted to operate in a country where financial institutions are exempted from VAT. Most countries use taxation as a means to attract foreign and international companies to invest in their countries. Therefore, in other countries the government can decide to introduce some reliefs from the tax for certain sectors in order to attract and encourage foreign investment.

Furthermore, exemptions can also be introduced in cases where the predecessor tax like sales tax was narrowly applied by excluding many services. Therefore a new tax does not want to be seen as extending the tax base as this can result in resentment of the tax amongst some of these social sectors. In this sense, exemption is used for social reasons and to give time to the public and business entities to understand and accept the new tax. This means that the base can be extended after a considerable time period.

Exemption of some sectors (such as services) from VAT can result in less administration in relation to paper work which has to be checked. It can also reduce the number of registered business entities and taxpayers. Furthermore, where the administration lacks well trained and skilled staff, it can be an advantage to leave out some sectors from the tax to avoid complexity⁸⁴ which can result from the need to separate taxed inputs and those which are not taxed, where the exemption is partial.

Though in practice most countries do leave out some services and sectors from the tax net, this can have disadvantages to the tax system and it can also result in some kind of discrimination between taxed and untaxed sectors. Therefore, this approach can

⁸³ See Jourbert, *The Law of South Africa*, 2002 Vol.22 Part 2, First Reissue (Lexis Nexis Butterworths: Durban) p.135

⁸⁴ It is also acknowledged that exemption can also have the effect of increasing complexity where the services of a sector are partly exempted and partly standard rated

be criticised for the following reasons: - firstly, it can be argued that exemption results in cascading since the exempt business entity and its customers cannot receive input tax credit. This means that the exempt business entity will have to charge VAT on products which already bear VAT. In this way, exemption results in charging tax on products which have been taxed already without any relief to remove or recover the tax which has been charged in the earlier stage of the chain.

Secondly, business entities producing both exempt and taxable (including zero rated) items must allocate inputs between the exempt and non-exempt categories, and this is difficult to accomplish in any non-arbitrary way and to control.⁸⁵ This can be complicated to some of the business entities and difficult to fulfil. This problem is likely to emerge mainly in developing countries as the entities may not find it easy to treat these categories separately and to clearly identify them. It is also likely to increase administrative costs to check and monitor the business entity's tax returns whether they reflect the correct status of the transactions.

It is clear from this discussion that these two concepts of exemption and zero-rating are different. The main difference between exemption and zero-rating lies on the treatment of a business entity under the two notions. As we have seen an exempt business entity is not part of the VAT system at all and this means the business has to pay VAT on its inputs, but is not permitted to claim any credit for the tax incurred. Therefore, an exempt business entity effectively passes this VAT to the consumer. On the other hand zero-rating enables the business entity to become part of the VAT system through registration. As part of the VAT system, the entity is required to keep all its input invoices for purposes of reclaiming credit on the VAT which is paid on its inputs. This enables the business entity that deals in zero-rated products to be part of the VAT system and is able to gain some benefits from the system. This point is summarised in the following quotation, "zero-rating in VAT is in reality a subsidy resulting in regular repayments of tax to those who sell zero-rated goods because since they are still making taxable supplies, they will have no output tax (zero-rated) but will be able to reclaim

⁸⁵ Due, J.F., "Some Unresolved Issues in Design and Implementation of Value Added Taxes" *National Tax Journal*, 1990 Vol.43, No.4, pp.383-394 p.385

their input tax”.⁸⁶ However, from the administrative perspective dealing with this category of business entity is administratively expensive and time consuming without bringing any benefit to the system.

The third feature of a VAT is the use of two inter-jurisdictional principles in inter-state taxation which are the origin principle and the destination principle. The origin principle charges tax on a transaction in a state where the transaction originates or where the goods which are supplied under the transaction were produced. This principle requires that tax be imposed at the point of production and in principle everything that is produced domestically is taxed. In effect exports are taxed while imports are not. “In VAT exports will be subject to tax and credit is given in importing country at the rate applied there”.⁸⁷ This means that when the goods are exported they already bear the tax of the state of production and the goods have to be relieved from further tax in the importing state. This is done by “giving credit in the importing country at the rate of tax applied there.”⁸⁸ In effect this principle eliminates borders in the sense that there is no need for border tax adjustment as the tax is imposed purely on domestic value added. The origin principle is applied by the Brazilian States and is viewed to have resulted in “distortions and administrative problems which had to be alleviated by imposing lower rates on interstate trade which has resulted in carousel types of evasion and by introducing some border controls between states”.⁸⁹

In contrast the destination principle charges tax at the point of consumption. This principle requires that all the goods and services that are domestically consumed are taxed in that state (where they are consumed). Therefore the destination principle zero-rates exports and imposes tax on imports. The taxation of imports as opposed to exports requires border tax adjustments as the VAT must be deducted (removed) from products

⁸⁶ Morse, G., and Williams, D., *Davies: Principles of Tax Law* 4th ed. 2000 (Sweet and Maxwell: London) p.430

⁸⁷ See Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues” op.cit. p.20

⁸⁸ Ibid

⁸⁹ Cnossen, S., “Global Trends and Issues in Value Added Taxation” op.cit. p.411, note 111

leaving the state and then added upon entry in the importing state. Exporters are therefore expected to declare their export values, so that they can be refunded their inputs on the goods. In most cases this does not create any problems since, “generally exporters have no incentives to under-declare their export values, and similarly importers have no incentives to overvalue their imports.”⁹⁰

Most countries in practice with a few exceptions, have adopted the destination principle with respect to the implementation of VAT. For example, the EU member countries have adopted the destination principle under the transitional system (though there are proposals to move to the definitive system which will tax on origin principle) and other countries such as South Africa, Kenya, Lesotho, Botswana and Namibia have also adopted the principle.

Fourthly, VAT is also characterised by three possible methods of computation. The first one is the invoice-credit method, whereby each trader charges output tax at the specified rate on each sale and passes to the purchaser an invoice showing the amount of tax which is charged. This method requires business entities to pay tax on the value of their gross receipts minus a credit for taxes paid on their purchases of intermediate goods and services as recorded on their business invoices. This method “computes the tax by applying the tax rate to sales and then subtracting taxes paid on purchases of components”.⁹¹ It requires the tax of the purchases to be clearly shown on the invoices so that the tax can be identified and thereafter subtracted from the total of the prices of the sales transactions completed. Therefore it imposes an administrative burden on the registered business entities to maintain detailed records of their transactions and enables the cross checking of the records to ensure that VAT shown on the sales invoice of one business entity is the same as the VAT shown on the purchase order of another business entity. The system introduces an element of self-policing by the business entities to ensure that VAT is accordingly paid in every stage of production and an invoice serves as evidence of such a transaction. This mechanism involving the requirement of

⁹⁰ Cnossen, S., *Issues in Adopting and Designing a Value-Added Tax*, op.cit. p.41

⁹¹ Rubling, C., “A Value Added Tax and Factors Affecting Its Economic Impact” in *Federal Reserve Bank of St Louis publication*, 1973 p.16

purchases being accompanied by an invoice provides strong incentives for business entities to complete the invoices accurately.

The second method is the subtraction method. This method levies tax directly on an accounts based measure of value added calculated for each firm by subtracting allowable purchases from revenues. This means that firms pay tax on the value of their gross receipts minus the costs of intermediate goods and services they purchase in the course of doing business. This approach employs the use of two systems: One system is called the 'sales-or cost-subtraction method' which deducts a firm's outlays on intermediate products from its taxable sales. The other system is referred to as the 'tax-credit method'. This method deducts the value-added tax which the firm pays on its purchases from the value-added tax due on its sales.⁹² (This can be expressed also as value added is measured as the difference between the value of outputs and inputs.)

Lastly, there is the addition method. This method calculates the firm's tax base by adding up all the components of value added which constitute payments for untaxed inputs. These are profits, wages, labour costs, and costs of capital and rent. The amount of VAT which is due is calculated by multiplying the firms' value added by the VAT rate which is applicable. For example, where x is the tax rate, the formula is $x(\text{Wages} + \text{profits})$ ⁹³ and the result thereof amounts to VAT which has to be paid over to the revenue office. The addition method does not rely on invoices which are passed from one business entity to the other.

Each of these computations yields essentially the same value added base though most writers in this subject tend to agree that the invoice credit method has got some advantages over the addition and subtraction methods. The invoice credit method makes the tax easy to trace, as a result of the invoices which are passed from one trader to another. It creates a good audit trail and therefore the invoice becomes the crucial evidence for the transaction and the tax liability. This also helps the business entities to improve their own record keeping as they have to record every transaction accurately. In this way the tax is able to successfully police itself through the invoices which are

⁹² Ogley, A., *Principles of Value Added Tax: A European Perspective* op.cit. p.3

⁹³ Tait, A.A., *Value Added Tax*, op.cit p.2

passed between the traders. This is emphasized in the following quotation; ⁹⁴“Self-policing is a desired character of the VAT and is specifically related to the invoice-based credit VAT”. Furthermore, the invoice method permits the firms to calculate their tax liability weekly, monthly, quarterly or even annually. It is argued that it is the only method that allows the most up-to-date assessments and allows more than a single rate to be used.⁹⁵

Value added taxes in European countries are usually computed by the invoice credit method. The following example illustrates how VAT is calculated on the basis of the method. A (makes bricks from raw materials acquired without costs), B (runs a building and hardware shop and buys the bricks directly from A to sell to the public), and C (is the customer who buys the bricks to build a pavement in his garden). A sells the bricks to B at £100 (ignoring the VAT), and B sells the bricks to C for £300. The value added by A is therefore £100 and by B is £200. A and B are both fully registered for VAT. It can be assumed that the rate of VAT in their country Y is 10 percent.

A sells the bricks to B for £100 including a 10 percent VAT (which A must add to the price). This means effectively B pays £110. A must account to the tax authorities for the VAT of £10 and keep a profit of £100. Similarly, B sells the bricks to C for £300 and he must also add the 10 percent VAT accordingly. This means C pays £330 in total for the bricks. B is entitled to be paid back (by the tax authorities) for the VAT paid to A, so he retains £10 of the VAT collected. B must therefore account to the tax authorities for the other £20, keeping a profit of £200. The reason why B's profit is £200 is because the net cost of B buying from A is £100, not £110, since the £10 is for VAT. The tax authorities receive £30 in total, £10 from A and £20 from B. This therefore reflects the value added by both A and B. This has to be reflected in the invoices which have to be passed from the seller to the purchaser and finally to the consumer, copies of which are available to the revenue authorities.

In contrast, the VAT liability can also be computed by the subtraction method. This method requires the computation of VAT liability by deducting the aggregate of the

⁹⁴ Ibid p.12

⁹⁵ Ibid

value of purchases which is £300 in the example from the value of the sales which is £330. The difference between the two which is £30 is taxed. This method of computation does not rely on invoices as documentary evidence on the payment of VAT in previous stages. Instead, the method requires accurate accounts of a firm in order to work out the value added.

In contrast the addition method tends to rely on accurate accounts information for wages and profits. This means the firms should keep accurate records of the amount of wages which are paid out and the firm's profit. The accuracy of the information which has to be engaged and relied upon under this method can be a problem for developing countries, where record keeping and accountancy has not been fully achieved and understood by the firms. Therefore that can be a huge set back for the addition method. This is quite problematic for those in business who are not acquainted with accounting skills. This method tends to be more complicated than the other two methods.

Fifthly, VAT is more difficult to evade and avoid than other sales taxes with the use of the invoice-credit system. This method helps to guard against evasion and avoidance as it leaves a trail of invoices (as discussed above) that may be easily followed by tax auditors. The use of invoices forms an integral part of VAT and its effectiveness. The firm which is entitled to claim a credit will insist on getting an invoice and it will be easy to trace the transaction and easier to determine the tax which has to be paid and which has not been paid. This process makes the VAT system more effective, reliable and spreads the burden of the obligation amongst all the participants throughout the chain of production.

The consequence of the VAT characteristics is that the tax tends to be operated as a self-assessing tax. This results from the fact that the registered business entities are under an obligation to complete their own VAT returns based on the information from the invoices obtained and assess their tax liability accordingly. However, the tax authorities have to check and verify the information, based on the information supplied by the business. This principle has been questioned with respect to developing countries as to whether it can be implemented effectively. This view is based on the problems

which are inherent in the tax systems of these developing countries. (This issue is beyond the discussions in this thesis, therefore, it is only dealt with where it relates to the tax system in Lesotho).

Though VAT is favoured by the majority of countries there have been criticisms made against the tax. VAT is mainly criticised for being regressive⁹⁶, in the sense that it falls more on the poor than the rich. This means that the burden of VAT does not depend on the level of their ability to pay or on their income. This is the case where VAT is implemented as a broad-based tax with one standard rate which falls more heavily on the poor, in the sense that “the VAT payment by low-income households will be a higher proportion of their incomes (and expenditures) than payments by higher-income households.”⁹⁷ Therefore, it is argued that in general consumption taxes are regressive and since VAT is a consumption tax it is regressive.⁹⁸

A lot of countries have introduced measures to deal with the regressivity of VAT. In most cases, the VAT system introduces different ways of taxing the different items; that is a lower rate or a zero-rate is introduced to tax essential items which are consumed more by the poor, while the luxury items which are consumed more by the rich are taxed at a higher rate than the standard rate. For example, some countries zero-rate food in general, while some countries zero-rate specified categories of food and other essential items. The South African VAT system can be used as an example of a system where basic food necessities are zero-rated in order to relieve the burden of tax from low income households. The basis of zero-rating such items arises from the fact that “a large part of the population in South Africa is unable to pay for basic necessities such as food, shelter and clothing.”⁹⁹ The Lesotho VAT system also provides for zero-rating of some basic necessities and this is discussed in chapter 3.

⁹⁶ See Tait, A.A., *Value Added Tax: International Practice and Problems* 1988 (IMF: Washington, D.C.) p.214; and Bickley, J.M., *Value Added-Tax: Concepts, Policy Issues, and OECD Experiences* op.cit. pp.18-19

⁹⁷ Tait, A.A., *Value Added Tax: Administrative and Policy Issues, Occassional Paper* 88 (1991) (IMF:Washsington, D.C.) at p.5

⁹⁸ Carlson, G., N., and Patrick, M., K., “Addressing the Regressivity of a Value-Added Tax” *National Tax Journal* 1989 Vol.42, no.3 pp339-351 at p.339

⁹⁹ Botes, M., “Regressivity of VAT-The First Decade’s Experience in South Africa” 2001 *VAT Monitor* pp237-244 at p.238

Furthermore, the use of multiple rates (including a zero-rate) in a VAT system can be criticised for complicating the system and having an effect on the administrative costs. This has raised concerns that VAT is an expensive tax to administer and to comply with, in the sense that a zero-rate involves collecting tax from business entities and later refunding it to the same business entities. This increases the administration burden of registering the business entities and also dealing with their tax returns. This also has an impact on the compliance costs of the business entities. Therefore, in most cases a simple VAT with one rate or two is recommended to overcome these problems which are associated with the use of zero-rate and multiple rates.

2.5 Conclusion on the Principles and Structure of VAT

Although the specific reasons for adopting VAT differ from one country to another, international practice has shown that the principles discussed above underlie the basic structure of this tax as it is implemented around the world. VAT has therefore turned out to be efficient and contributed to the stability of most tax systems in a number of countries. Some of the features which make it attractive are its revenue raising potential and neutrality aspect. Similarly it is agreed that a properly designed VAT raises more revenue with lower administrative and economic costs than other broadly consumption taxes.¹⁰⁰ VAT however, cannot be considered in isolation but it has to be judged in terms of the economic, fiscal, political and social factors which exist in the country and in the broader context of the existing tax system.

It appears from the discussion that a favourable VAT structure is one which is simple to comply with and simply to administer; VAT which does not result in consumer and producer distortions; and a VAT system with one rate which extends to all goods and services.

¹⁰⁰ Cnossen, S., "Global Trends and Issues in Value Added Taxation" op.cit. p.399

2.6 A comparison of Sales Taxes and VAT

2.6.1 Introduction

Most of the tax reforms which have taken place in the last century have centred on the introduction of a VAT and the restructuring of the tax administration structures and strategies, especially in developing countries.

In most countries VAT was adopted to replace either one or more of the existing types of sales taxes. These included manufacturing tax, wholesale tax and a retail sales tax. These types of taxes are classified as single-stage taxes. The single-stage taxes are defined “as general consumption taxes on a range of products levied predominantly at only one stage in the chain of production from manufacturer to wholesaler to retailer to consumer”.¹⁰¹ Single-stage taxes work in such a way that the tax charged is suspended on transactions between manufacturers and retailers by registered traders but takes effect on sales to unregistered persons. The effect is that the tax is only collected at the end of the chain from the consumer.

The single-stage taxes can be contrasted with the multi-stage taxes whereby tax is charged at every stage of production each time the goods are sold. The multi-stage taxes can be sub-divided into two types. First, those kinds of taxes where no credit is given to traders for tax paid on the purchase of their inputs (referred to as ‘cascade’ or turnover taxes without credits). Secondly, there are those taxes where tax paid by traders on their purchases is generally refunded on the purchase of their inputs. These types of taxes are usually referred to as value added taxes.

For the purposes of this study the discussion is narrowed to focus on the comparison of general sales tax (a single-stage tax) and VAT (a multi-stage tax). The reason is that this comparative analysis is discussed in the context of the position in Lesotho where VAT was introduced to replace a (general) retail sales tax.

¹⁰¹ OECD, *Taxing Consumption*, op.cit. p.64

Despite the widespread implementation of VAT throughout the world, there are countries such as the United States which continue to implement a retail sales tax both at the national level and sub-national level.

2.6.2 Principles and basic design of Sales Tax

In most countries sales tax is viewed as an alternative to VAT. Sales tax is a single-stage levy of tax which applies to the sale for final consumption. The final purchaser in this case may either be an individual consumer or a business firm purchasing for its own use rather than for resale or a small trader not required to register.¹⁰² The important aspect of determining the tax liability under sales tax is the purpose of the purchase rather than the nature of the “vendor” (the term is used to mean a registered trader). This means it is important to determine whether the purpose of the purchase is for resale or for own use by the consumer or other registered business entity. However this is true to the extent that the registered business entity is the final purchaser and not the consumer or an unregistered small business entity, in the sense that only the registered business entity can make a purchase which is intended for further supply if the purchase is not for own use.

The basis of taxation under sales tax is the retail price, bearing in mind that the tax does not only cover retailers, but all other entrepreneurs dealing directly with final consumers. Where the wholesaler, distributor or the manufacturer sells directly to final consumers, sales tax is charged on such a supply. The rationale behind this principle is the fact that the tax applies to all sales for consumption by the purchaser and excludes all sales of inputs to businesses.¹⁰³ This takes into consideration the fact that there are different types of business entities that can deal directly with private consumers in the chain of production. It can also be argued that this in some way ensures that the tax is

¹⁰² Due, J.F., *Indirect Taxation in Developing Economies: The Role and Structure of Customs Duties, Excises, and Sales Taxes*, op.cit. p.102

¹⁰³ Mikesell, J.L., brief entitled “Retail Sales Tax” p.2

<http://www.worldbank.org/publicsector/tax/retailtax.htm> (site visited on July 11, 2003)

not charged on items which bear tax from earlier transactions since the sales tax does not have a mechanism to recover any input tax by the registered business entity.

Sales tax requires all business entities including manufacturing and wholesale establishments, making sales at retail to register. However, only retail firms above the minimum threshold which has been set by the government (in terms of their turnover) are required to register. This is in recognition of the fact that the smaller retailers particularly cannot be registered. However, in practice in most systems smaller businesses have an option to register if they wish. The consequence of registration is that, the retailers are entitled to collect tax from their customers. Sales tax applies in two types of situations:¹⁰⁴ (1) when a registered firm sells to a non-registered buyer that is, a final consumer or an unregistered small firm and (2) when a registered firm sells to another registered firm for taxable use (or consumption and not for resale). The liability for reporting and paying the tax in the second situation may rest upon the buyer or the seller, both of whom are registered vendors. In effect sales taxes exempt transactions between registered traders from tax. This means “the application of the tax is suspended until a sale to an unregistered trader or final consumer occurs”.¹⁰⁵ Effectively, tax is collected only at the last stage of the production and distribution chain, which is the retail stage on all sales for consumption to the purchaser.

In respect of tax rates, sales taxes are usually imposed at a single rate and also administered at low rates of up to 10 per cent. This is intended to reduce recordkeeping and reporting requirements for registered firms and to ensure that they do undertake their obligations effectively. This also is said to ‘eliminate the possibility of evasion by improper categorization of transactions at a lower than appropriate rate’.¹⁰⁶ The reason is that a high rate of sales tax increases the risk of evasion and avoidance. It is argued that a high rate sales tax would be difficult to administer, for example “at 5 per cent the

¹⁰⁴ Due, J.F., *Indirect Taxation in Developing Economies: The Role and Structure of Customs Duties, Excises, and Sales Taxes*, op.cit. p.102

¹⁰⁵ Ogley, A., *Principles of Value Added Tax: A European Perspective*, op.cit. p.7

¹⁰⁶ Mikesell, J.L., brief entitled “Retail Sales Tax”, op.cit. p.4

incentive to evade is probably not worth the penalties of prosecution, at 10 per cent evasion is more attractive and at 15-20 per cent, becomes extremely tempting.”¹⁰⁷

Similarly, Tanzi¹⁰⁸ concludes that 10 per cent may well be the maximum rate feasible under a sales tax. In Lesotho VAT was adopted to replace a sales tax which was only collected at the retail stage. The tax was called a general sales tax (referred to as a sales tax in this study) and it was levied at the rate of 10 per cent.

2.7 Comparison of VAT and Sales Tax

It is generally agreed that both retail sales tax and VAT aim to be taxes on final domestic consumption and have similar economic effects. The difference between them follows from the method of collecting the tax. As a single-stage tax, sales tax involves a suspensive mechanism of collecting tax at the stage where the final consumer is involved. Sales tax employs a suspensive mechanism of levying tax in the sense that primary producers, wholesalers and retailers are generally required to register and account for tax on sales of goods to non-registered persons (usually consumers). On the other hand, the producers, wholesalers and retailers may buy and sell between themselves without liability to tax, provided that such goods are not for their own private use. In this sense payment of tax is suspended until the final stage, when the goods are sold by registered traders to unregistered traders or consumers.¹⁰⁹ In contrast, as a multi-stage tax VAT is charged and collected at every stage of the production chain with the use of a repayment system of VAT to registered business entities.

The comparison of VAT and sales tax often tends to focus on the following policy implications for the two taxes: administrative and compliance costs; tax avoidance and tax evasion control; extent of tax base (extent of coverage of goods and services); tax rates; exclusion of certain goods and sectors from tax; time required to implement each tax and the revenue efficiency of each of the tax. It is argued that from

¹⁰⁷ Tait, A.A., *Value Added Tax: International Practice and Problems*, op.cit. p.18

¹⁰⁸ Tanzi, V., *Taxation in an Integrating World* 1995 (Brookings Institution: Washington D.C.) pp50-51 in Ebrill, L., et.al, *The Modern VAT*, op.cit. p.23

¹⁰⁹ OECD, *Taxing Consumption*, op.cit. p.97

an economic perspective, VAT and sales tax are widely perceived to be equivalent.¹¹⁰ The important questions which need to be examined are; - firstly, what is the difference between a VAT and Sales taxes and secondly, why has VAT gained more support than sales taxes?

The first point of comparison is that VAT is collected at each stage of the production process. In this way, VAT is charged on transactions between registered businesses which are allowed to recover VAT paid in respect of their inputs. This means that the tax liability risk of VAT at any stage involves only a small amount of the total tax, which as argued by Zodrow “reduces both the incentive to cheat and the revenue lost with successful cheating at any stage of the production process.”¹¹¹

In contrast sales tax is collected by retailers or other business entities at the final sale to the purchaser. This means that all the tax liability is concentrated at the retail stage. “The danger here is that if some businesses succeed in evasion of tax, either by slipping out of the tax net, then the revenues of the country will immediately drop.”¹¹²

From this perspective VAT is considered superior to sales tax in this regard since it is less risky in terms of revenue leakage. The fact that VAT is collected at every stage of production means that if the tax is missed in one stage there is an opportunity to collect it at the next stage. The level of revenue lost will not be as much as the revenue lost under sales tax which is collected at one stage only.

Furthermore, for the small retailers the retail stage is the weakest link of the production and distribution chain for collection of tax. That makes it easier to lose the bulk of the revenue where evasion and avoidance are high. This administrative difference of collection of the tax between the sales taxes and VAT has led VAT to gain more support over sales tax. It is easier to collect tax from the business entities themselves at the different stages, as they have to provide all the necessary invoices which can be easily traced for audit purposes. In contrast under sales tax the burden of

¹¹⁰ Zodrow, G.R., “The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a “VAT in Drag”?” *National Tax Journal*, 1999 Vol.52 no.3 pp.429-442 at p.431

¹¹¹ Ibid

¹¹² Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, op.cit. p.6

collecting the tax lies with one retailer at the end of the production and distribution stage or with a business entity that sells to an unregistered trader.

Secondly, VAT requires that businesses charge tax on their sales and subsequently “they can offset the tax they have paid on their own purchase of goods and services against the tax they charge on their sales of those goods and services”.¹¹³ This means that the firm can recover its input tax against the output tax it has incurred and it ensures that VAT is not charged to business inputs. This mechanism makes VAT more appealing to traders. The inputs are therefore freed from tax, as opposed to taxation under a sales tax system. However, as it is correctly argued by Tait¹¹⁴ it does not mean that all business inputs are free of tax under a VAT, as some inputs such as inputs into financial services are taxed. It is in the self-interest of a registered firm to have accurate purchase invoices so that it can obtain full credit for prior VAT paid. Tax authorities are also in a position to double check the accuracy of the VAT remitted by any registered firm because data is collected from producers at all levels of production.

In contrast under a sales tax business entities are issued with an exemption certificate which in theory permits them to purchase business inputs on a tax-exempt basis.¹¹⁵ This practice can be criticised for opening doors for fraud. For example, in some instances the businesses can use the exemption certificates to purchase their own goods for consumption which are actually chargeable to sales tax and escape paying sales tax in that case (they can use their exemption certificate and pretend the goods are going to be sold and taxed accordingly). Moreover since not all the businesses will qualify for the exemption certificates, there is a likelihood of abuse by exchanging the certificates with businesses which do not have them to gain advantage from the exemptions.¹¹⁶

Thirdly, the administrative and compliance costs constitute another point of comparison between sales taxes and VAT. VAT requires detailed accounts of both

¹¹³ Ebrill, L., et.al, *The Modern VAT*, op.cit. p.1

¹¹⁴ Tait, A.A., (ed.) *Value Added Tax: Administrative and Policy Issues*, op.cit. p.4

¹¹⁵ Zodrow, G.R., “The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a “VAT in Drag”?”, op.cit. p.432

¹¹⁶ See paragraph 2.8 on the problems which were caused by the use of exemption certificates under sales tax in Lesotho.

purchases and sales of registered traders, whereas a sales tax is only concerned with their sales. The compliance requirements under VAT will increase the compliance costs of the businesses. This involves keeping detailed accounts for audit purposes and some of the business entities may have to involve accountants to assist them in undertaking the task. This involves payments which have to be made to third parties for their expertise. As regards compliance costs, business entities will incur more compliance costs under a VAT system because they are required to keep detailed records of the business. This may entail getting qualified people to deal with the accounting to deal with that. This will increase the compliance, whereas sales taxes do not impose such a high burden of compliance. This constitutes a significant point of comparison between the two taxes as it is one area where sales tax has an advantage over VAT. "It is a matter of some surprise that, despite this significant disadvantage (of VAT), international organizations are so eager to recommend the introduction of VAT in less developed economies".¹¹⁷ However, on the other hand this can be seen as an advantage to the business, as it is in its own interest to have accurate documents and purchase invoices for purposes of obtaining full credit for VAT paid in the earlier stage.

Administrative costs of a VAT are likely to exceed those of a sales tax. Under a VAT system, the administration has to check through all the records of the businesses including the invoices to ensure that they are genuine and correctly completed to avoid possibilities of false information and invoices for refund purposes. Further, since the tax base of the VAT is wider than the tax base of sales taxes, this means more business entities must be registered and this results in more tax returns to be made and dealt with by the administration. VAT covers both goods and services and there is need in some cases to separate services and goods which are taxable and those which are exempt. This means that the administration has to monitor the tax returns and refund claims which relate to zero-rated items.

¹¹⁷ Ogley, A., *Principles of Value Added Tax: A European Perspective*, op.cit. p.7

Monitoring of refund claims also extends to exporters and therefore, there is a need on the administration side to monitor the claims to detect fraudulent claims, false invoices and fictitious business entities in that respect. There is a need to tighten administration measures to guard against multiple claims which the business entities can make and to ensure that invoices are correctly completed to avoid understated transactions of taxable goods and services. Therefore this will result in high administration costs. On the other hand, in most cases sales taxes are only confined to cover goods and therefore they have a narrow base which is less costly to monitor by the administration. Furthermore, under sales taxes tax returns are completed only at the stage where the tax is levied and this results in less tax returns to deal with and there are fewer registered taxpayers as it is the case under VAT.

Further, it seems in practice there is a perception that the legal framework and administration to implement sales tax is simpler than the VAT legal framework.¹¹⁸ The mechanism to recover input tax and to calculate the value-added could seem complicated from the businesses' perspective particularly when the tax is first introduced. However, this can be addressed through training and awareness programmes by the tax administration. The point here is that though VAT can be seen as complicated because it is a new tax method, this can be expected to change once the tax has been in place for a reasonable period of time.

A VAT is considered to be more complicated as it covers a larger number of business entities as compared to sales tax. Another argument is that a sales tax is cheaper to implement since it can be introduced much more quickly than a VAT because of its simplicity. However, with the spread of VAT in both developed and developing countries, one can argue that VAT has now become well-known and as a result the time it takes to introduce the tax has shortened considerably. Some writers consider that 18

¹¹⁸ See Zodrow G.R., "The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a "VAT in Drag"?", op.cit. p.436 and Bickley, J.M., "A Value-Added Tax Contrasted with a National Sales Tax" *Issue Brief for Congress*, March 19, 2003 (Congressional Research Service: The Library of Congress) p.1

months is a reasonable time.¹¹⁹ For example in Lesotho there was a preparation time of about 6 months only before VAT was introduced.

The administrative costs of undertaking preparations for the introduction of VAT are likely to be higher for the government, since this involves training of administrative staff, establishing various technical departments, computerisation of the tax system, training businesses and increasing public awareness of the new tax system.

Another advantage of VAT from the business entities' perspective is that it helps them to keep their accounting records up to date and this makes it easier for their trading activity in general. The managers' and staff are able to gain some kind of specialised skills, which are accounting and tax skills in dealing with VAT.

Fourthly, another point of comparison relates to the tax base (of the two taxes). VAT is a more broad-based tax than sales taxes. This means that it is able to cover both goods and services and this removes any discriminatory treatment between the two sectors. Sales taxes are regarded as less effective in taxing services and in practice most sales tax systems taxed only goods. The argument is that "there is no 'tax credit' link with suppliers and no 'automatic' sorting out of taxable and non-taxable customers".¹²⁰ It seems the problem with taxing services is that it is difficult to separate the use and nature of certain items and to determine their end use. For example services such as transport, telecommunications, professional services and construction are not usually taxed under sales tax, and when they are, it is at very low rates. In practice it is difficult to monitor whether the services are used for personal use or for business purposes (a dual or mixed use). Therefore, this creates a problem in apportioning the tax to the two categories. For example, even with goods it is difficult to distinguish between an exempt item and taxable item as it is not clear when a retailer purchases sugar whether it is going to be used to sweeten tea at home (which may warrant the sugar being taxable) or as an exempt ingredient for taxable bakery products.¹²¹ This problem is worse with services.

¹¹⁹ Tait, A.A., *Value Added Tax: International Practice and Problems*, op.cit. p.55

¹²⁰ Cnossen, S., "Issues in Adopting and Designing a Value-Added Tax" p.80 in Sandford, C., *Key Issues in Tax Reform*, op.cit.

¹²¹ Sugar is taxable in Lesotho, whereas it is a zero-rated foodstuff in the United Kingdom

The fifth point of comparison relates to the methods of computation. VAT has also been favoured mainly for its credit invoice method which is used in nearly all countries and is believed to be a mechanism favourable to reducing tax evasion. This method as discussed above entitles the firm to charge tax on all of its sales and receive a credit for tax paid by its suppliers, provided that such tax is shown on the firm's invoices. The important element under this method is the supply of the invoice which states that the purchasing firm has paid tax to the supplier. This is an advantage to VAT since the credit invoice method leaves a trail of invoices which may be easily followed by tax auditors.

The use of invoices makes it possible for the tax authorities to cross-check claims for tax credits made by firms against taxes paid by their suppliers. This discourages tax evasion by the business entities since it is easy to trace. By comparison, no such trail of invoices is required under a sales tax, and "even cross-checking the claims of retailers and their suppliers is impossible."¹²² Under a sales tax the only evidence available may be till receipts as cash sales are very common. There may not be any evidence of a transaction available.

The sixth point of comparison is the issue of revenue contribution and efficiency of VAT and sales taxes. One can provide that the efficiency and revenue potential of these taxes will depend on their base (coverage) and their rates. A comparison of the rates of the two taxes shows that in most cases VAT rates are substantially higher than the rates of sales tax (for the standard rates of VAT particularly in Sub-Saharan Africa see Table 1). As discussed above, in practice sales tax has been implemented at rates lower than 10 per cent. However some countries have implemented sales tax at higher rates.¹²³ Furthermore, on the point of revenue efficiency of VAT it can be argued that since VAT is able to tax a broader range of goods and services it is likely to result in more revenue for the government than sales tax. Though VAT tax a broader range of

¹²² Zodrow, G.R., "The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a "VAT in Drag"?", op.cit. p.432

¹²³ For example, South Africa operated a sales tax at the rate of 12 per cent, while Iceland implemented sales tax at 25 percent and Zimbabwe at 15 percent – see Tait, A.A., *Value Added Tax: International Practice and Problems*, op.cit. p.18

goods and services, it also exempts some services and zero-rates some goods. Therefore, to ensure that VAT raises substantial revenue, the tax rate tends to be higher than the rate of sales tax.

Another point of consideration for comparative analysis of sales tax and VAT is whether sales taxes or VAT can either be included or excluded from the sales price. The question here is whether it is possible to include or quote a sales tax or VAT with the sale price of an item or the tax has to be quoted separately? In some countries sales tax is quoted separately whereas in other countries it is included in the purchase price. It is possible for both sales tax and VAT either to be included with the sale price or shown separately from the sales price on the consumer receipts. This is a point of policy consideration which each country has to deal with taking into account its impact on the consumers and vendors. The question is whether the consumers and vendors will react positively or negatively to the tax if it is hidden in the sale price or when it is quoted separately. From individual experiences with the approach to tax in either case, it can be concluded that for mental accounting of both the consumer and the vendor, it is easier to deal with the tax when it is included in the sale price of the item. On the other hand, it is also advantageous for the tax to be quoted separately so that the consumer and the vendor should know exactly the amount which has to be paid over to the government.

The other important question relates to whether VAT has raised more revenue than the taxes it has replaced. This seems to be inconclusive according to the study which the IMF carried out in 2001. The revenue efficiency of VAT in Lesotho is highlighted in chapter 4. However the statistics which are referred to are used to examine the collection of VAT by the different units in Lesotho. The issue of whether VAT raises more revenue than the sales tax which it replaced in Lesotho cannot be conclusively dealt with since some of the records of the revenue collection under sales tax system were incomplete.

It seems to emerge from this comparative analysis that VAT has more advantages than a sales tax. However, it is important to consider the points highlighted in making the choice between the two systems, while at the same time taking into consideration the economic conditions and needs of each country. Though it seems VAT

is not a cheap tax to administer or to comply with, it can be argued that the benefits of this tax outweigh the costs.

2.8 The Lesotho Sales Tax System: Reasons for Introducing VAT in Lesotho

Lesotho's sales tax was levied on imports of goods and services at the rate of 10 percent. It was also levied on sales by a limited number of registered "vendors"¹²⁴ both to final consumers and to other business entities that were not registered. Since 1993¹²⁵ the minimum annual turnover of businesses in order to qualify for registration was M500, 000 (Five Hundred Thousand *Maloti*).¹²⁶ Registered vendors were exempted from sales tax on their imports and on most of their sales to other registered vendors. This was to ensure that final consumers of goods and services would bear tax only once, either on importation or on their purchase of goods and services from registered vendors. In practice, final consumers could effectively bear tax at a higher rate in some cases if any taxed goods or services were used by the registered vendor as an input into the final product (this would result in "tax on tax," which is referred to as cascading). The tax extended through to the retailer and this means no tax was paid between the stage of manufacturing and retailing if all the traders in those categories were registered vendors. The tax was only collected at the retail stage when the goods or services were being sold to the final consumer or to an unregistered small trader or to a registered vendor for their own use not for resale.

In 1996¹²⁷ the government introduced three main changes to the tax.¹²⁸ First, the annual turnover threshold which applied for businesses to register was reduced from

¹²⁴ In terms of *section 3* of the Sales Tax Act No. 14 of 1995 "vendor" means a person who is, or is required to apply to be registered under the Act

¹²⁵ The major problems which undermined sales tax in Lesotho were identified at this time with the team from the IMF (FAD) initial study and recommendation to move to VAT, see the report by, Hemming, R., Walton, G., and Bristow, J., "Lesotho: From General Sales Tax to Value-Added Tax", May 1993

¹²⁶ This would be about £38,628 (converted on 21st July, 2006)

¹²⁷ Lesotho Sales Tax Act No.14 of 1995

¹²⁸ See King J., Walsh J.T., and Laycock, I., King J., "Lesotho: Implementing the VAT and Strengthening Tax Administration", op.cit. p.10

M500, 000 to M250, 000.00 (Two Hundred and Fifty *Maloti*). This meant that minimum threshold extended to include very small business entities that were obliged to register. This would certainly create administrative problems for the system as the number of registered vendors would increase. Therefore, effectively there would be more tax returns to be dealt with by the administration and a large number of vendors to monitor under the system. Secondly, *section 16* of the Act made a distinction between the effect of registration and certificates of exemption. Registration under *section 16 (1)* made a business liable to tax on its taxable supplies whereas certificates of exemption exempted a registered business from tax on most of its purchases of goods and services in terms of *section 16 (8)*. Therefore in terms of *section 6 (2)* sales tax was not payable in respect of a supply to or an import by a vendor of goods or services where the vendor had at the time of the supply or import, produced the vendor's sales tax exemption certificate to the prescribed person.

Registered businesses could apply for exemption from sales tax but the Commissioner of Sales Tax had the discretion as to whether to issue such exemption. Every case was considered on its own merits based on the information which the Commissioner had in relation to the business entity. Those who were granted exemption by the Commissioner were issued with exemption certificates. These certificates granted a vendor with an advantage of being exempted from sales tax at the time of supply if the supplier was a registered vendor.

Thirdly an "input tax credit" mechanism was introduced for businesses that were registered but did not hold an exemption certificate. This mechanism meant that for those businesses who did not have exemption certificates, tax would be payable on their sales of goods and services, but a credit would be given against "output tax" for any sales tax that had been paid on their purchases of goods and services. In terms of *section 20 (1)* a credit was allowed to a taxable vendor for input tax paid in respect of a taxable supply to or an import by the vendor of goods or services. This provision introduced a similar mechanism which exists under VAT which allows a registered vendor to recover credit for input tax paid in a previous transaction for a taxable supply.

For purposes of administration and effective implementation of the amendments, the business entities were divided into three groups and sales tax was charged differently to the entities in the different categories:¹²⁹ First, for businesses that were ‘neither registered nor exempt’, sales tax was very similar in effect to an import duty, levied on their purchased inputs; Second, for those that were ‘registered but not exempt’, the tax was very similar to a VAT of the “invoice-credit” type. This means that businesses were required to request invoices from the sellers (registered) and also expected to issue invoices to their buyers. The invoice was a proof of payment of tax incurred in the previous taxable supply. This was important for purposes of claiming credit on their inputs; Third, for those that were ‘both registered and exempt’, the tax was a basic sales tax designed to ensure as far as possible that tax was paid only once on sales to final consumers. This category of businesses were exempted from sales tax on their purchases but allowed to charge sales tax to the final consumers.

During this period, the main challenge for the government was to provide effective administration for the different categories of business entities for the liability of sales tax. However, in practice the administration mechanisms of sales tax at the time proved to be very poor. This was caused by the fact that administration burden had increased due to categorisation of business entities and the administration lacked skills to deal effectively with the second category of business entities. This had tremendous impact on the effectiveness of the system as a whole and also affected the revenue collection. These administrative challenges resulted mainly from the nature of the sales tax system, particularly the changes which were made in 1996 which are outlined above.

From the interviews¹³⁰ which were conducted with the officials in the VAT division, it became clear that the “exemption certificates” under the sales tax system were abused by traders. They were required to produce their certificates at all times when they were making purchases, but this was not done in practice. Traders would only quote their certificate number without actually producing the certificate itself. They would also lend their certificates to be used by traders who do not qualify under the

¹²⁹ Ibid

¹³⁰ Interview with the Principal Collector – VAT Division, January 2004

exemption scheme for them to be exempted from payment of sales tax too. In this way a lot of traders were able to avoid payment of sales tax. This indicates that there was indeed some kind of collusion which was going on between the manufacturers, wholesalers and retailers in the use of exemption certificates. This practice however, could have been stopped and monitored closely if the administration mechanisms were not weak.

There were increasing difficulties which the government experienced in administering sales tax, particularly in respect of those businesses to which the input tax credit mechanism has been applied. These businesses constituted about 600 of the 1,900 businesses that were registered as vendors liable to pay sales tax. The sales tax officials did not have the necessary skills to determine and deal with “input tax credit”. This resulted in “the Sales Tax Department raising the registration threshold in April 2000 from M250, 000 (*Maloti*) to 2million (*Maloti*).”¹³¹ This measure reduced the number of businesses liable to sales tax from 1,900 to around 80, all of whom were exempt from tax on their inputs. This resulted in leaving a lot of businesses outside the tax net and huge revenue loss was to be expected. This meant that there were no longer any businesses which would fall under the category of businesses which would use the input and credit mechanism which had been introduced in 1996.

Sales tax administration remained a great concern at the time. The significant concern was total lack of management information regarding number of returns processed each month; number of audits undertaken and the assessments issued as a result of the audits; number of refunds processed and amount of refunds issued out to the vendors. In this way the management could not have adequate information on vendors who were in arrears since even the filing system was not up to date. It also appeared that the department was not actually enforcing the provisions of the Act relating to imposition of penalties to business entities that did not keep records within the country as required by the provisions of the Sales Tax Act. This went to show the extent of how weak the sales tax administration was and how the businesses could get

¹³¹ See King, J., Walsh, J.T., and Laycock, I., “Lesotho: Implementing the VAT and Strengthening Tax Administration” op.cit. p.11

away without paying any tax due to the government.

Furthermore, it appeared that there was lack of up to date information on the revenue which is collected from the tax. This was part of a general problem of lack of records and information to compile accurate reports on revenue collection. This problem became evident when I was carrying out research at the LRA. Reports on revenue collection during the sales tax system were incomplete. This can be interpreted to represent one of the weaknesses of the sales tax administration. The fact that there were no accurate records on the status of the revenue from sales tax can be regarded as a huge setback to the system since revenue collection is the most important aspect of a tax system.

The administration of sales tax in Lesotho was also undermined by shortage of tax inspectors who could regularly engage in visits to the business entities, those who were registered and those who were not.¹³² The importance of these visits to the business premises is to establish whether there are any businesses which are required to register but have not done so; or whether the business entity is properly charging sales tax accordingly and observing its obligations. Furthermore, visits by inspectors are important in order to assist business entities in any issues and problems with understanding their obligations or the system in general. The existence of tax inspectors is an important part of any tax system.

The sales tax system in Lesotho was also undermined by lack of skilled and qualified personnel.¹³³ Since at the time the sales tax department was a governmental department, it seems the staff (as part of the civil service) was regulated by the civil service regulations and payment schedules which were low. It can therefore be argued that the conditions of work at the department also contributed to the administrative problems particularly in attracting skilled personnel.

¹³² Interview with the Principal Collector – VAT Division, February 2004

¹³³ I observed that a lot of qualified and highly skilled people did not work for a continuous long period of time at this department. They would leave to go to the private sector or other better paying sectors

Another administrative challenge to the system resulted from smuggling of goods into Lesotho from South Africa. This resulted from the differences of tax rates which existed in Lesotho and South Africa. In practice it appeared that some people importing into Lesotho would not declare their goods voluntarily unless the sales tax officials undertook thorough checks of the vehicles and what was loaded. This effectively meant that the importers were avoiding paying sales tax¹³⁴ and this in general undermined the administration.

The position in Lesotho towards imported goods was that, sales tax was charged at the border posts upon importation of such goods. Most imports into Lesotho are from South Africa and the administrative arrangements in imposing and collecting sales tax were therefore important. Taxable goods which were purchased in South Africa but subsequently exported to Lesotho (or any other SACU member country) qualified for a refund of the tax when they were exported from South Africa. Before the goods were exported from South Africa the person exporting the goods (trader or consumer) was entitled to a refund from the VAT Refund Administrator¹³⁵ (with officers at the South African side of the border posts with Lesotho). The Administrator could only pay up to R3, 000 (Three Thousand *Rand*) and any amount which was above that was refunded by the revenue administration in South Africa. The refund was only paid if it was claimed by the trader or consumer exporting goods from South Africa.

In practice this meant that those who imported into Lesotho would claim VAT (14 per cent standard rate in South Africa) on the South African border posts and pay sales tax (10 per cent) in Lesotho upon importation of the goods. This practice resulted in long queues on both sides of the borders. It also resulted in delays of some refunds from the South African VAT Refund administrator while the Lesotho revenue authorities demanded payment of sales tax before the goods could be imported into the country. This caused some inconvenience to traders and individual shoppers that imported goods which were chargeable to sales tax.

¹³⁴ Information obtained from a Senior Customs official in an interview in February, 2004

¹³⁵ The VAT Refund Administrator is a private company under contract to the government of South Africa and operates at five major border crossing into Lesotho

Furthermore, this procedure was undermined by problems resulting from underdeclaration and underreporting of the actual sales by some of the importers of goods into Lesotho. This happened where the seller in South Africa colluded with the buyer from Lesotho to issue two invoices and receipts to the buyer. Therefore the buyer would hand the invoice which reflects the actual price which has been paid for the goods, to claim the refund at 14 per cent at the South African border. When they got to the Lesotho border post, they would submit the other invoice which reflects a lower price of the goods, in order to pay less sales tax for the imported goods. From a different point of view, the arrangements under sales tax seemed to have been favoured by some people who imported goods into Lesotho. They argued that they were able to get an advantage from an inefficient tax administration, as they could claim on the South Africa side, but escape payment of sales tax in Lesotho. (This point cannot be substantiated, but did come up as one of the problems which undermined the sales tax system from interviews with VAT officials).¹³⁶

As a result of the identified challenges to the sales tax system, the government was prompted to consider other options of trying to improve its tax administration strategies with the aim of increasing its revenue collection. Lesotho's options in reviewing its tax structure and system are constrained by its membership of SACU, which sets the level and structure of import and excise duties. Further, the fact that it is a small economy in a customs union with its much larger neighbour South Africa, also places limits on its ability to increase tax rates on both incomes and goods, because any rates that are out of line with South Africa's could be expected to result in migration and smuggling. In view of these considerations, the government invited the IMF team (FAD)¹³⁷ to undertake studies generally in relation to the implementation of the sales tax and on strengthening tax administration. From the various visits and studies which the IMF undertook, they summarised the problems of the tax system at the time and made recommendations thereof.

¹³⁶ Information obtained from an interview with a Senior Customs official, February 2004

¹³⁷ See King, J., Walsh, J.T., and Laycock, I., "Lesotho: Implementing the VAT and Strengthening Tax Administration" op.cit. p.3

A further assessment which was made in 1996 by the IMF mission endorsed the previous recommendations that sales tax be converted into a VAT. Further they recommended that all the provisions relating to exemption certificates in the Act should be removed, thus eliminating the third category of businesses.¹³⁸ This was intended to ensure that all the businesses are registered and will deal with sales tax in the same way as under a VAT, in order to give the administration and the businesses the opportunity to gain experience with how a VAT operates. The IMF also had an interest to ensure that the tax system would be moving towards the direction of a VAT. However, IMF's recommendations were not implemented and this meant the administration of sales tax did not in any way improve.

Following from years of consultations with the IMF team, the government of Lesotho adopted reform strategies which the team had recommended to the tax system. These included an establishment of an independent national revenue authority and the introduction of VAT in place of a sales tax.

2.9 Conclusion

This chapter has attempted to discuss the features and design of a VAT as a tax. The structure represents the design of VAT in most of the countries where it is adopted. However, in practice countries have adopted different designs of VAT systems, though most of them have incorporated the features which are discussed in this chapter within their systems. It is noted that VAT is an important development in indirect taxation.

It seems that a properly designed and administered VAT can result in economic efficiency and revenue efficiency within a state. However, at the same time governments should be committed to creating a stable environment within a country for VAT to be effectively implemented. Where a VAT system is poorly designed and administered, it can be distortionary and expensive to administer; fail to raise substantial revenue and cause resentment amongst the business entities and the public.

¹³⁸ Ibid p.11, footnote 2 which refers to the report by Zee, H., and Russell, B., "Lesotho: Progress and Needed Measures in Sales Tax Reform", May 1996 IMF/FAD

The discussion has also revealed that VAT still fails to cover all the services such as financial services, transport services and postal services. This indicates that VAT is still developing and has to adapt to the new methods of international trade and concluding taxable transactions.

Another area of concern towards a VAT system relates to the use of zero-rate and exemption to relieve some items and services from tax. The inclusion of reliefs within a VAT system tends to complicate the system. However on the other hand, the use of zero-ratings in most countries, particularly developing countries, in relation to basic food items and other necessities is to alleviate the burden of VAT on those who are poor. The effect of zero-rating such basic necessities does not necessarily benefit only the poor, but tends to benefit the rich even more. However, until governments revert to other means to alleviate poverty and to create more jobs or use other taxes to relief the burden of taxation on the poor, it seems that VAT remains at the centre of such a purpose.

The continuing spread of VAT around the world particularly in developing countries is an indication that it has more advantages than sales tax. However, it is also important to ensure that the administrative structures for the implementation of the tax are in place and have the full support of the government and sufficient resources. This is to avoid problems such as those which undermined the sales tax system in Lesotho. It can be concluded therefore that the major problem of the sales tax system in Lesotho was its administration and in that way, the government could have concentrated on improving the administration of sales tax rather than replacing the tax with a different tax system. This could have resulted in fewer costs than those incurred setting up the implementation of VAT.

**PART II: A CRITICAL ANALYSIS OF THE VAT SYSTEM IN
LESOTHO WITH PARTICULAR EMPHASIS ON ITS
ADMINISTRATION AND IMPLEMENTATION**

Chapter 3: The Introduction and Implementation of Value Added Tax in Lesotho: The Legal Framework

3.1 Introduction

This chapter examines the legal regime for VAT and the general structure of VAT in Lesotho. The principles of VAT which form part of the legal structure are examined and discussed in reference to the general principles of VAT. In Lesotho there have not yet been any decided cases on the VAT legal system and this has created a gap in the sense of judicial authority in this area of the law. The analysis of the structure of VAT in Lesotho makes reference to judicial decisions from other jurisdictions in dealing with the VAT concepts and principles which are widely accepted. There is little doubt that when a court in Lesotho is faced with a similar issue it will refer to decided cases from other jurisdictions (with similar legal systems)¹³⁹ particularly decided cases from South Africa (where they are applicable) and from the UK¹⁴⁰.

3.2 The Legal Framework of VAT in Lesotho

From as early as 1997, the government already had plans to introduce VAT. However, it was not until 2000 that the first VAT draft legislation was concluded. It was revised in 2001 and came into force in 2003. The VAT legal regime in Lesotho comprises the Value Added Tax Act No.77 of 2001; the Value Added Tax (Amendment) Act 2003; the Value Added Tax Regulations, 2003; and the Value Added Tax Act 2001 (Threshold for Registration of Vendors) Notice 2003.

¹³⁹ The legal system in Lesotho has inherited both the English Common Law and the Roman Dutch Law (South Africa's legal system) while the customary law still forms part of the legal system.

¹⁴⁰ Please note that such references to cases from other jurisdictions are by way of illustration only, rather than by detailed examination of the VAT regime in those jurisdictions.

The VAT legal system in Lesotho is developed and based to some extent on the legislation from other countries, such as South Africa, New Zealand and Zambia.¹⁴¹ (With the proximity of South Africa, the government had to ensure that the VAT system is aligned with the South African VAT system. Therefore the South African Revenue Service worked closely with the Lesotho Revenue Authority). The drafters of the legislation in Lesotho aimed at developing a simple structure of VAT as recommended by the IMF team and this is evident from the VAT Acts and the Regulations. The tax covers all goods and services with limited zero-rates and exemptions. The tax extends through all stages of value added to the retail stage, in keeping with its predecessor, sales tax.

3.3 Structure of the Lesotho VAT system

The three key questions which are relevant in discussing and developing the structure of VAT are: who are the taxpayers? On what are they to be taxed? And when and how much tax is to be paid?¹⁴² These questions guide the discussions on the structure of VAT in Lesotho. For the purposes of VAT, the taxpayers of VAT are the final consumers, who actually buy the goods and services. The final consumers are the ones who bear the tax as the burden to pay falls on them upon receiving a taxable supply and they are strictly speaking the 'taxpayers'. However, the legal obligation to account for the tax is placed on those that supply the goods and the services. In order to avoid the confusion between the use of terms between the person who bears the economic incidence of the tax and the person who is legally obliged to account for the tax, the legal term used in Lesotho is 'vendor'¹⁴³ which means a person who is or is treated as registered under the VAT Act. The UK uses the term 'taxable persons'¹⁴⁴ which means an individual, firm or company which is registered for VAT or which is required to register for VAT but has

¹⁴¹ Information obtained from an interview with the Assistant Commissioner in the VAT Division, LRA January 2004 Lesotho

¹⁴² See Morse, G., and Williams, D., *Davies: Principles of Tax Law* 5thed, op.cit. p.409

¹⁴³ Section 3, Lesotho Value Added Tax Act, 2001

¹⁴⁴ UK VAT Act 1994

failed to do so. South Africa also uses the term 'vendor'. It means a person who is either registered or who is required to register.¹⁴⁵

VAT is charged on every taxable supply and every taxable import into Lesotho.¹⁴⁶ Taxable supply means a supply of goods or services (which excludes an exempt supply) which is made in Lesotho by a vendor for consideration in the course or furtherance of an enterprise carried on by the vendor.¹⁴⁷ This provision recognises that there are some supplies which are exempted from VAT. The key concepts which are important in determining whether a transaction is taxable are: - (1) the supply (2) of goods or services (3) by a vendor (4) for consideration and (5) in the course or furtherance of an enterprise.

Section 13 of the VAT Act defines taxable import as an import of goods and services unless it is an exempt import. An 'import' in terms of *section 11 (1)* means to bring goods into Lesotho from a foreign country or place. In the case of services, 'import' means a supply of services by a person in the course of an enterprise carried on outside Lesotho where the services are for use or consumption in Lesotho where the following three conditions exist:- first, where the services are supplied by electronic means such as television or Internet; second, where an importer of the services is an importer whose business was registered in Lesotho, it shall be the importer who is liable to pay tax on the taxable import; and third, where such foreign supplier conducts sufficient business in Lesotho to the extent that such cable television or other service may be treated as supplied in Lesotho and not imported.¹⁴⁸ These provisions are aimed to ensure that the services of a business entity that is not necessarily carrying out any business activities in Lesotho are chargeable to VAT particularly where the services are consumed or used in Lesotho. For example, an Internet provider company which is carrying on an enterprise in South Africa, but provides Internet services (broadband) in Lesotho, such services are classified as imports and are chargeable to VAT in

¹⁴⁵ Section 1v, South African (SA) Value Added Tax Act 89, 1991

¹⁴⁶ Section 5, Lesotho VAT Act 2001

¹⁴⁷ Section 12, Lesotho VAT Act 2001

¹⁴⁸ Section 11 (1) (b), Lesotho VAT Act as amended by Section 7 (b), Lesotho VAT (Amendment) Act 2003

Lesotho.¹⁴⁹ However, the difficulty in implementing this provision is that it can be difficult to prove or monitor the use of such services by the tax officials unlike where the import of goods is concerned.

The base of the tax is the value added to consumer goods and services within Lesotho and the value of imports. The tax is therefore not charged on exports of goods and exports of services, as they are zero-rated. The consequence of this principle is that exporters are entitled to claim refunds or input tax deductions for their exports (this is the case whether or not such goods or services are normally taxable when supplied domestically). Exporters are still required to register and to file their tax returns like other registered business entities. They have to produce invoices for their refund claims and also have proof that the goods were exported.

Another consideration in examining the structure of VAT is to look at the coverage of the tax, that is, the extent to which it covers various entities. The tax can be structured to extend to manufacturers, wholesalers and to retailers. For example when VAT was introduced in Kenya, it was restricted in the goods-supplying sectors to the manufacturing level only. This meant the registration requirements were limited to manufacturers of taxable goods with turnovers above a minimum level. Other countries restricted their VAT coverage to the wholesale stage, such as Nigeria (1993). Most countries in the world have a VAT which extends to the retail stage. For example this is the case in all the member countries in the EU, other European countries and most countries in Sub-Saharan Africa with a VAT, including Lesotho and other SACU member countries. The widely accepted view on this issue is that “a ‘good and inclusive’ VAT should make all entities liable to tax that produce goods and services. This means manufacturers, wholesalers and retailers should all be registered”.¹⁵⁰

¹⁴⁹ The business entity that is an ‘importer’ under this provision is required to register for VAT in Lesotho accordingly in terms of Section 9(6), Lesotho VAT Act (Amendment) Act 2003 as discussed at paragraph 3.3.8

¹⁵⁰ Cnossen, S., “Global Trends and Issues in Value Added Taxation” op.cit. p.401

3.3.1 Meaning of “Supply”

VAT liability arises where there is a supply of goods and services. The first inquiry is to determine whether a transaction is a ‘supply’ for purposes of VAT. What constitutes a supply? The Lesotho VAT law does not define what constitutes a supply, but rather highlights what constitutes a supply of goods and services. Reference can also be made to the South African VAT law (SA VAT). The term ‘supply’ is not defined, but is said to include ‘performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected’¹⁵¹.

Similarly, the UK VAT law does not define the term ‘supply’. Rather it relies on judicial decisions which deal with the interpretation of the term. This approach has been adopted in SA law and in the absence of judicial decisions in Lesotho on the issue, the approach will also be significant for the interpretation of the provision of the law in Lesotho.

The New Zealand and the United Kingdom Courts have interpreted the concept to include a number of factors. These factors can also be used to guide the judiciary in Lesotho in the interpretation of the term;¹⁵²

(1) The word ‘supply’ has a wide meaning; in its ordinary and natural sense it means to furnish or serve; - this was discussed in the UK case of *Carlton Lodge Club v Customs and Excise Commissioners*¹⁵³.

(2) The supply of goods implies a passing of the possession of the goods. However, both the supplier and the recipient of the goods must have agreed, to part with and to receive the goods; this principle was discussed in the decision of *Customs and*

¹⁵¹ Section 1, SA VAT Act 89, 1991

¹⁵² Jourbert, *The Law of South Africa*, op.cit p.104

¹⁵³ [1975] STC 507 - An unincorporated members’ club sold alcoholic drinks to its members. It applied for its VAT registration to be cancelled. The Commissioners rejected the application as the club’s supplies exceeded the registration threshold. The club appealed, arguing that since the members were already part-owners of its stock of drinks, it was not supplying them to its members. The tribunal rejected this argument and dismissed the appeal. The QB upheld this decision, holding on the evidence that the club was supplying its drinks to its members, notwithstanding the fact that the members were already part-owners of the club’s stock.

*Excise Commissioners v Oliver*¹⁵⁴ where the Court noted that the phrase ‘supply of goods’ has a wide interpretation. It is ‘the passing of possession in goods pursuant to an agreement where the supplier agrees to part and the recipient agrees to possession’. By ‘possession’ is meant in this context control over the goods, in the sense of having immediate ability to use them. (The facts of the case appear below in point 4). This principle can be extended to the supply of services, in that where the supplier of services agrees to provide services and does indeed provide the services and the recipient agrees to the services being rendered, it can be argued that it qualifies as a transfer of the control over the benefits which flow from the services.

(3) The supply need not necessarily be by way of sale. However, it will include an agreement of sale and purchase between the two parties.

(4) The judicial decisions do confirm that if a sale does occur and the contract between the supplier and the purchaser is void, the supplier is still obliged to charge VAT. Reference can be made to the decision in *Oliver* where a second-hand dealer sold a number of stolen cars at auction. The dealer did not account for VAT on the sales and he was assessed for tax on the amounts he received. On appeal the dealer argued that there had been no supply since he did not own the cars. The Court rejected this argument and held that the fact that the dealer had no legal title to the cars did not change the fact that he had supplied them. The Court interpreted this phrase ‘supply of goods’ to mean ‘the passing of possession in goods on the basis of an agreement where the supplier agrees to part and the recipient agrees to possession’.

The requirements for a ‘supply’ of services were discussed in *Tolsma v Inspecteur der Omzetbelasting Leeuwarden*¹⁵⁵ where the court emphasised that there must be an agreement between the supplier of services and the recipient to the supply of

¹⁵⁴ QB [1980] 1 All E.R. 353, [1980] STC 73

¹⁵⁵ C-16/93 - In this case a Dutch organ grinder who played a barrel organ on the public highway, and invited donations from the public, was held not to be supplying services for a consideration. Tolsma played an organ on the public highways soliciting for money. Some people passing by gave some money, others continued their walk while some merely stopped to listen. According to the Court, there was no agreement between the parties and also ‘no necessary link between the musical service and the payment to which it gave rise’. Therefore the Dutch organ grinder was not making a supply of services for consideration.

services. Another important element in regard to a supply of services is that there must be a link between the supply and the payment which is made.

It appears from the decision in *Oliver* that supply is determined by ‘passing possession’ of what is supplied. It is important to examine what possession actually means. Does possession mean the right to use, or does it require title? Can a supplier pass possession of what does not legally belong to him or what he does not legally own? Can a supplier only pass possession where he has rightful title or right to use only? These issues are discussed in the context of different scenarios which are highlighted below.

A distinction has to be made between a transaction which involves the supply of illegal items and items which are stolen from an innocent owner. A transaction which involves the sale of illegal items does not prevent the imposition of VAT if it can be established that the other requirements of a ‘supply’ exist. This should be contrasted with a situation where the goods are stolen from the rightful owner by the thief. In this latter case, the owner cannot be said to have ‘supplied’ the goods to the thief since it cannot be argued that there is a relationship between a supplier and the recipient. In this way, the two would not have entered in any agreement to pass possession of the goods. This means the owner is not deemed to have made a supply to the thief. However, with respect to the earlier situation, even if the goods were stolen when they are sold by the ‘thief’, they are chargeable to VAT. The ‘thief’ cannot claim lack of legal title to the goods when he is expected to account for VAT to the tax authorities as authoritatively laid down by the court in *Oliver’s* decision.

The rationale behind this principle on illegal supplies is based on the well defended principle of fiscal neutrality. “The principle of fiscal requirements requires that all supplies of goods for consideration are subject to VAT unless the goods are subject to a total prohibition on circulation because they are harmful.”¹⁵⁶ This point was laid down

¹⁵⁶ Wareham, R., and Dolton, A., *Tolley’s Value Added Tax*, 1st ed., 1999-2000 (The Bath Press: United Kingdom) 1999 p.927

by the European Court of Justice in *Witzemann v Hauptzollamt Munchen-Mitte*¹⁵⁷ where the court in a German case ruled that the importation of counterfeit money was outside the scope of VAT. The Advocate-General stated that ‘a line must be drawn between, on the one hand, transactions that lie so clearly outside the sphere of legitimate economic activity that, instead of being taxed, they can only be the subject of criminal prosecution and, on the other hand, transactions which, though unlawful, must none the less be taxed, if only for the sake of ensuring, in the name of fiscal neutrality, that the criminal is not treated more favourably than the legitimate trader’.

The principle which the ECJ lays down in *Witzemann’s* seems to be decided on the basis of equity (fairness) of equal treatment between a criminal and a legitimate trader. However, it can be argued that though this is in accordance with fiscal neutrality, it is against social and moral practices. In a way the criminal’s right to dispose the goods and his false claim to ‘title’ is recognised. On the other hand it can be argued that it is not up to the revenue authorities to decide whether an individual has the right to title which enables them to pass that right to another person, as long as they have possession of what is being supplied. It can be presumed that once the matter has come before the courts, such issues should be taken into consideration. Fiscal and economic issues do not exist in isolation, but are considered in the broader context of the political, social and cultural issues.

The cases of illegal supplies should be distinguished from a case where the vendor has supplied goods which belong to him and the consideration made towards the supply is subsequently stolen by the staff.¹⁵⁸ In such a case, there has been a legal supply by the owner to the customer, despite the fact that the consideration was subsequently stolen. The decision in *G Benton* raises some controversy in relation to the principle of equity. The question which arises is whether this principle is fair – did the proprietor have to be liable for tax though the consideration was stolen by the staff? It can be

¹⁵⁷ C-343/89

¹⁵⁸ For example, in *G Benton* [1975] VATTR 138 which concerned stolen takings is a decision on this principle. In that case, a hotel proprietor appealed against an estimated assessment contending that the underdeclared takings had been stolen by dishonest bar staff. The tribunal held that the proprietor was still liable to account for tax on the stolen takings, as the time of supply was when the goods were handed to the customer.

argued that the principle of fairness should not be stretched too far, since it is the responsibility of the proprietor to ensure that the consideration which is received is safely guarded.

These cases should be distinguished again from those where a supply of goods constitutes a supply of an illegal product or a restricted product (by the laws of the country). For example, in Lesotho the sale and use of a noxious substance called *dagga* (which is a type of a drug which is widely used) is illegal under the Public Health Code. Therefore the supply of *dagga* does not constitute a supply since the substance is prohibited and its use amounts to a criminal offence. In many developing countries, theft and circulation of stolen goods is a widespread practice, and will give rise to the question of liability of VAT. Most goods which are stolen are sold to innocent consumers or traders by misrepresentation that they are either new or second-hand goods. The revenue authorities (and the courts) have to decide whether a supply of stolen goods is a supply and raises VAT liability. A thief cannot claim legal title, but does have possession of the goods. The question is whether under such circumstances the thief can claim to pass the title (at least for VAT purposes) which he does not have to another person under a transaction which can be classified as a supply and gives rise to tax liability? In this particular situation I think the thief should be liable for VAT under such circumstances.

A similar position exists in the UK and within the EU, as the illegal sale of drugs is not a supply for VAT purposes under *Article 2* of the Sixth EU Directive. This was discussed by the CJEC in two Dutch cases namely; *Mol v Inspecteur de Invoerrechten en Accijnzen*¹⁵⁹ and *Vereniging Happy Family Rustenburgstrat v Inspecteur der Omzetbelating*¹⁶⁰. The Court held that the illegal sale of drugs such as amphetamines or hashish was not an 'economic activity' and does not constitute a supply for VAT purposes. The Court emphasised that, "while the principle of fiscal neutrality precluded a 'generalised differentiation between lawful and unlawful transactions', supplies of narcotic drugs were outside the scope of this principle." The circulation of narcotic

¹⁵⁹ CJEC case 269/86 (1988) ECR 3627

¹⁶⁰ CJEC case 289/86 (1988) ECR 3655

drugs is prohibited in all the Member States except in cases where they are used for medical and scientific purposes.

These cases demonstrate that where a supply of goods involves restricted or prohibited goods such as drugs, whose use is allowed for medical reasons only, this will not constitute a taxable supply since the transaction is unlawful. These cases can therefore be distinguished from two other ECJ decisions on selling counterfeit perfume and exporting information systems which was banned by the EC.¹⁶¹

The cases which are highlighted illustrate some of the different situations under which transactions can be held to qualify as taxable supply or not, particularly where there is an element of 'illegality' with respect to the goods which are being supplied or where the use and supply of goods are restricted by legislation.

3.3.2 Supply of Goods

The Lesotho law makes a distinction between a supply of goods and a supply of services. There are different rules which apply with respect to each type of supply. The rules are discussed in separate sections below. The question that arises is why is there a need to distinguish between 'goods' and 'services' in discussing the rules of supply? It has been argued that the differences between the two "lies in the rules locating either a

¹⁶¹ The first case is *R v Goodwin and Unstead* (CJEC case C3-/97 (1988) STC 699) where two individuals were convicted for selling counterfeit perfume against the provisions of *section 72* of the UK VAT Act. They appealed, contending that VAT was not chargeable on counterfeit goods. The case was referred to the CJEC to decide whether counterfeit goods were within the scope of *Article 2* of the EC Sixth Directive. The CJEC held that the supply of counterfeit perfumes was within *Article 2* and therefore was chargeable to VAT. The court held that the prohibition on counterfeit products such as perfumes, 'stemmed from the fact that they infringed intellectual property rights and was conditional, not absolute as in the case of narcotics or counterfeit currency'.

The second case which can be distinguished is a German case, *Lange v Finanzamt Furstenfeldbruck* (CJEC Case C-111/92 [1993] 1 ECR 4677) where a trader exported information systems to countries in respect of which the Community had imposed a ban on such exports. The German authorities imposed VAT and the trader appealed, arguing that the exports were exempt under *Article 15* of the EC Sixth Directive notwithstanding the illegality of the exports. The case was referred to the CJEC. The court held that the principle of tax neutrality precluded a generalised distinction between lawful and unlawful transactions and distinguished this case from the two Dutch cases on the basis that they concerned goods 'which, because of their special characteristics may not be placed on the market or incorporated into economic channels'. Therefore the court upheld the trader's argument that the transactions were exempt.

supply of goods or a supply of services which tend to differ as well as the rules which determine when such supplies occur”¹⁶². These rules are looked at in both cases.

Generally goods are defined to include all kinds of tangible movable and immovable property, but do not include money. In terms of *section 8 (2)* a supply of goods means any arrangement under which the owner of the goods parts or will part with possession of the goods. This should include an agreement for sale and purchase between the owner of the goods and the purchaser. This may include land, a house and any real right in such immovable property. It may also include such things as shares, bonds and business assets. The definition however, does not include consignments or a transfer of possession of goods to a person in a representative capacity.

The definition of a supply of goods introduces some terms which are not defined in the Act and the VAT Commissioner has to interpret such terms in the context of the taxable supply concerned. For example, the provision states that ‘the owner of the goods parts or will part with possession of the goods’. This provision presupposes that it is only the ‘owner’ who is entitled to part with possession and transfer the possession of goods to the other person. The question that arises is what will be the position where a person in a representative capacity transfers the goods to the other person? Can that amount to transfer of possession of the goods under the Act? It can be argued that relevant rules relating to the law of agency will be referred to in such situations which means if the person who claims to be an agent is indeed acting on behalf of the principal, and transferring of the goods in question are part of the conditions of the agency, therefore the agent can in the legal sense ‘part with possession and transfer the possession of the goods’.

Generally a “supply of goods” is not constituted merely by a transfer of possession, which does not constitute the transfer of the goods, “but rather constitutes a transfer of the use of goods which amounts to a supply of services.”¹⁶³ If a transfer of possession (which is a supply of services) is followed by a transfer of the title, or rights

¹⁶² Williams, D., “Value-Added Tax”, op.cit.,p.188

¹⁶³ Ibid p.186

of ownership, the supply of goods is the supply of those rights. This means that there has to be a clear distinction between the value of the supply of goods and the supply of services in this particular case.

Furthermore, a supply of services which is incidental to the supply of goods is part of the supply of goods. For example, if a vendor deals in selling motor vehicles to its customers and in some cases has to deliver them to the customer, the service of delivery of the motor vehicle is incidental to the supply of the goods. Therefore the delivery charges are classified as part of the supply of goods. Since there are no cases in Lesotho, for purposes of illustration and by way of example, reference is made to legislative provisions in other countries to see how the concept 'goods' is defined. The South African legislation defines 'goods'¹⁶⁴ to include; corporeal, movable things; fixed property; and any real right in any such thing or fixed property.

Another important provision is *article 5(1)* of the Sixth EC Directive which defines supply of goods as, 'the transfer of the right to dispose of tangible property as owner'. The interpretation of the phrase has also developed through case law both by the UK courts and the ECJ. For example, the ECJ considered the meaning of the phrase in *Staatssecretaris van Financiën v Shipping and Forwarding Enterprise SAFE BV*¹⁶⁵ in relation to a property transaction. The Court confirmed that a supply of goods could occur even before the transfer of legal ownership, although the supplier should have the right to dispose of the property in question as owner.¹⁶⁶ This decision contains a similar principle as one in which appears in the Lesotho provision.

¹⁶⁴ Section 1(v), SA VAT Act

¹⁶⁵ (Case 320/88) (1990) I ECR 285; (1991) STC 627

¹⁶⁶ Another example is *Van Dijk's Boekhuis v Staatssecretaris van Financiën* (Case 139/84) [1986] 2 CMLR 57, where the taxpayer (Dutch) carried out repairs, some of which were extensive, on school books. The taxpayer argued that he was supplying goods, which under Dutch law were chargeable to VAT at 4%. The Dutch authorities considered that he was supplying services, which were chargeable at 18%. The ECJ held that the process undertaken by the contractor had to involve a change in the function of the materials originally provided for the provision to apply. The court concluded that repairs (however extensive) or restoration work did not amount to the supply of goods.

3.3.3 Supply of Services

The general practice amongst countries (as is shown below) is to define, ‘a supply of services’ as any supply that is not a supply of goods. In the Lesotho VAT Act, a supply of services is defined as “anything which is not a supply of goods or money but done for a consideration”. In terms of this definition this means that in order to determine whether a transaction amounts to a supply of services it is necessary to rely on the definitions of the two concepts of ‘services’ and ‘consideration’. In order to avoid any controversies, it is essential to identify the nature of the supply to determine whether it does amount to a supply of services. The Act explicitly provides that the following supplies are to be treated as supplies of services¹⁶⁷:-

- The performance of services for another person
- The making available of any facility or advantage
- The toleration of any situation or the refraining from the doing of any act; or
- The application by a vendor of services to own or exempt use, but only if the vendor has been allowed an input tax credit in respect of those services

A supply of services also includes a supply of goods incidental to the supply of services.¹⁶⁸ However, a supply of services incidental to the supply of goods is regarded as a supply of goods under the legislation.¹⁶⁹ This means that a vendor who supplies goods which are part of the supply of services will be classified as making a supply of services, which is the main activity in the supply under consideration. The legislation fails to define what ‘incidental’ means in the context of either supply of goods or services. This leaves the Commissioner to interpret what is incidental in each case.

In practice therefore, it can be argued that the supply of services can include for example, the supply of electricity, supply of internet services, photocopying, telecommunication services, supply of legal services, services by accountants and consultancies, and supplies of international travelling services.

¹⁶⁷ Section 8 (4), Lesotho VAT Act

¹⁶⁸ Section 8 (8), Lesotho VAT Act

¹⁶⁹ Section 8 (7), Lesotho VAT Act

To illustrate the position in other countries, reference can be made to the South African VAT law as an example. It defines services as “anything done or to be done, including the granting, assignment, cession or surrender of any right and the making available of any facility or advantage, but excluding a supply of goods, money or any stamp.”¹⁷⁰ In a rather different way, the UK legislation provides that ‘anything which is not a supply of goods but is done for a consideration is a supply of services’.¹⁷¹ This was discussed in *K Hodson v Commissioners*¹⁷². This decision indicates that for a supply of services to be taxable for VAT purposes the element of consideration is essential.

Another relevant decision is *Trinity Mirror plc (formerly Mirror Group Newspapers Ltd) v Customs and Excise Commissioners*¹⁷³ which extended the interpretation of ‘consideration’. The issue in this case was whether there had been a supply of services or not. The Court extended the principle in determining whether there has been a supply of services, when it said that the supply of services must be capable of being used by and for the benefit of an identified recipient. The benefit must be capable of being regarded as a cost component in the activity of another person in the commercial chain. In determining whether there has been a supply of services, it is crucial also to establish whether there has been a consideration and whether the transaction is a commercial one. The court concluded that there was a supply of services in *Trinity Mirror*.

¹⁷⁰ Section 1 (s v), SA VAT Act

¹⁷¹ Section 5 (2) (b) (3), UK VAT Act

¹⁷² MAN/89/606 (4709) – In this case a publican failed to account for VAT on receipts from a ‘payphone’ which he had installed in the public house. The Commissioners issued an assessment charging tax on the receipts and he appealed arguing that he should not have to account for VAT since he did not make a separate charge to the customers. The tribunal dismissed the appeal and held that the service was clearly a supply of services by the publican for consideration.

¹⁷³ [2003] STC 518 - In this case TM included in its input tax claim, the VAT on the fees of its legal and financial advisors, which had been incurred in connection with an issue of TM’s own shares issued in order to raise finance to expand its business

3.3.4 Taxable Supply

Another important question is whether a supply is 'taxable'. For a supply to be 'taxable', it should be made 'for consideration' in the 'course or furtherance of an enterprise' carried on by the vendor. These requirements are discussed separately below with the use of references and examples from other countries, since they have not been referred for judicial interpretation in Lesotho.

3.3.4.1 Consideration

Consideration is another important factor which is relevant in determining whether a transaction constitutes a supply for purposes of VAT. *Section 12*¹⁷⁴ provides that a (taxable) supply means a supply of goods and services made for 'consideration' in the course or furtherance of an enterprise carried on by the vendor. It is further provided that a supply is made for consideration if the person making the supply receives payment for the supply either wholly or partly in money or kind.¹⁷⁵ Consideration is defined to mean the total amount in money or in kind paid or payable for the supply. Consideration can include any duties, levies, fees or charges paid or payable for the supply or import of goods or services.¹⁷⁶

A supply is only subject to VAT if it is made for consideration, and this helps to determine the value of the supply. In economic terms it is crucial to establish the value of the supply and 'value is realised if the supplier gets paid for the supply. If nobody pays, there is no added value.'¹⁷⁷ It can be implied from this quotation that 'payment' is an integral part of determining whether consideration has been made. However, the manner of payment is not important, whether it is in kind or by any other means, as long as the payment can be valued. Therefore, consideration does not only mean payment in money, it can be any type of payment including payment in kind. But it is crucial that

¹⁷⁴ Lesotho VAT Act

¹⁷⁵ Section 12 (5), Lesotho VAT Act

¹⁷⁶ Section 3, Lesotho VAT Act

¹⁷⁷ Morse, G., and Williams, D., *Davies: Principles of Law* op.cit., p. 415 paragraph 24-12

the consideration should be 'paid or payable' to ensure that something is realised for the value of the supply. But it is not necessarily crucial whether it has actually been received. Consideration is anything which is provided in exchange for something else, where the one is conditional on the other.

The most important principle which the courts have laid down in establishing whether the supply is made for a consideration is that there should be a direct link between the supply and the consideration. It should be clearly established that the payment is for the supply under consideration.¹⁷⁸ It was noted in *Tolsma* that the requirement of consideration is essential for a supply to be a 'taxable supply' and there should be 'a link (connection) between the supply of both goods and services and the consideration (payment). Where a direct link between the payment and the supply is not clearly established there will be no supply for VAT purposes.

The decision in *Stewart v Customs and Excise Commissioners*¹⁷⁹ also discusses the 'direct link' test in establishing the element of consideration. In the context of VAT, consumption means the acquisition of the right to dispose of the goods as owner irrespective of the motive of the recipient of the goods. (In this case, the Government had acquired the firearms for destruction). There was the necessary direct link and a legal relationship between the supplier and the recipient so that the payment of compensation constituted consideration for the supply of the firearms.

Another relevant decision is *Customs and Excise Commissioners v Littlewoods Organisation plc*¹⁸⁰. In this case, L's retail goods were sold through the services of

¹⁷⁸ This principle was laid down in *Tolsma* (C-16/93)

¹⁷⁹ [2002] STC 255 - S carried on business selling and repairing guns. The Firearms (Amendment) Act 1997 made it an offence to own, make or sell most handguns. A scheme was set up whereby the owners of prohibited firearms were required to surrender them to the police in return for compensation. S surrendered firearms and ancillary equipment under the scheme and received compensation. Customs took the view that the surrender of firearms and ammunition constituted the making of a taxable supply and issued a VAT assessment. S argued that VAT was a tax on consumption and that the Government was not a consumer in respect of the guns surrendered, which were rendered worthless by the 1997 Act. The court dismissed the appeal and held that the surrender of firearms under the scheme was a transfer of the whole of the property in the goods under the VAT Act 1994 *Sch.4 para.1 (1)* and so constituted a supply for VAT purposes.

¹⁸⁰ [2000] STC 588

agents, who ordered goods for third parties and for themselves and who earned a commission when payments were remitted to L. It was agreed that the agents' commission of 10 per cent was a discount which reduced the amount of the supply of goods for tax purposes. However, agents were entitled to receive their commission in several ways, one of which was to receive an extra discount of 2.5 per cent where further goods were ordered. Customs argued that the additional 2.5 per cent should be regarded as consideration for services rendered and not as a discount off further goods and that it was within the taxable amount. Under the Sixth VAT Directive 77/388 *Art.11* "taxable amount" included consideration for services, but not price discounts. The question was whether the right to the commission is linked to the supply of goods or services to a third party, negotiated by the agent. On appeal by Customs, the court allowed the appeal and held that the enhanced commission was to be regarded as consideration for services and was, therefore, within the taxable amount. This meant that there was a direct link between the supply of the services by the agent to the main supplier and the commission which was payable to the agents.

The principles in these cases were extended in *Town and County Ltd Factors v Customs and Excise Commissioners*¹⁸¹ where reference was made to the ECJ for a preliminary ruling. The Court emphasised that a legal relationship existed between T and each entrant despite the fact that T's obligations as service provider were unenforceable.

A number of general conclusions can be drawn from these decisions in regard to the interpretation of the term 'consideration'. These are:-

- The concepts of profit and consideration are different. The fact that a trader does not make a profit on a supply does not mean that there is no consideration for the supply. This principle was laid down in *Heart of*

¹⁸¹ [2002] STC 1263 - The question was whether VAT was payable on the entry fees for a Spot the Ball competition, and if so, the amount payable. The company T, which was the competition organiser, argued that VAT was not payable as it was under no legal obligation to award prizes, being only honour bound to do so. T also argued that if VAT was payable, the taxable amount was the total of the fees received less the value of the prizes awarded. In giving the preliminary ruling, the ECJ held that for purposes of the Sixth VAT Directive *Article 2(1)*, the supply of services for consideration constituted a transaction subject to VAT even where the provider's obligations were not enforceable such as in the present case where T was only honour bound to provide the relevant services

Variety.¹⁸² The Lesotho legislation does not make any reference to profit in any of the provisions. Therefore, reference will be made to judicial decisions from other jurisdictions and it is likely that the courts will favour the approach adopted in *Heart of Variety* decision on the interpretation and applicability of the two concepts. It is also important to highlight that the consideration has to be directly linked to a supply of services of an economic nature.

- Where the vendor has supplied goods or services for reduced consideration (and for no profit), this is still treated as a supply for consideration. The Lesotho laws contain a similar principle and the rationale behind the principle is to avoid cases where suppliers can argue that 'reduced' payment (consideration) does not constitute actual payment. This is likely with retail suppliers either of clothing or households' items, which may be reduced at specific seasons, for example Christmas and New Year Season. They are likely to argue that during that period, since the goods are supplied at a reduced rate, that does not constitute consideration, and that therefore there was no taxable supply.
- The determining factor is whether the consideration is due, not whether it has been received. The decision in *G Benton* can be used as authority for this principle. It was held in that case that a vendor had to account for tax where the cash was diverted by an employee before being placed in the till as the time of supply was when the goods were handed to the customer.

¹⁸² [1975] VATTR 103 - In this case a charitable organisation (H) presented cinema films in Children's Homes throughout the country. To carry out this task it received the co-operation of a leading cinema operator (EMI) of which one of its members was an executive. Seven projectionists were used of whom five were 'borrowed' from EMI and two were engaged by H. These two were placed on EMI's payroll and the wages and expenses of all seven were paid through the wages office of EMI. H reimbursed EMI monthly for the amounts paid but EMI made no further charge for its services. The Commissioners issued a ruling that the arrangement involved a taxable supply of services by EMI and that EMI should account for output tax. H appealed. The tribunal dismissed the appeal noting that 'the concepts of consideration and profit are different, and the fact that a trader makes no profit on a supply does not mean that there is no consideration for it'.

- Whether or not consideration is due in respect of a supply is determined at the time the supply is deemed to occur. This principle was discussed in the *Potters Lodge Restaurant Ltd.*¹⁸³

Since the Act is very clear on what constitutes consideration, the Commissioners have to look at the requirements to classify a supply as a taxable supply 'made for consideration'. Consideration should amount to anything given in exchange of something else. For example, where a vendor supplies trucks to a buyer and as a condition of the supply, the buyer does not have to make payment for the trucks, but has the right of use and is required to pay a certain percentage of the profits from the use of the trucks to the vendor, that will be consideration. Similarly, where a contractor provides his services to build a shopping complex for a trader and as a form of payment, the contractor is given the right to use one block of the shopping complex for an agreed period of time, this amounts to a form of consideration. This requirement can also be considered in relation to the general practice in the country in relation to what is usually regarded as payment in kind.

In Lesotho, payment in kind would amount to an offer to provide some goods or services in return for a supply of other goods or services. For example, the situation could be that a vendor supplies motor vehicles to a registered retailer and the retailer, rather than making payment in money, offers to get the supplier more customers (retailers) to purchase the motor vehicles for resale. The monetary value in that payment in kind would amount to the fact that the supplier is able to get more customers and sell more motor vehicles.

¹⁸³ LON/79/286 (905) - where a company which was carrying on restaurant businesses failed to account for tax on the service charges which were included in the customers bills. The company issued bills to customers which included a 10 % service charge and the total, (including the service charge), was stated to be tax inclusive. The total of the service charge was paid to the waiters at the end of each day, to be shared between themselves. The Commissioners issued an assessment charging tax on the service charges and the tribunal dismissed the company's appeal. The Tribunal held that the service charge was part of the consideration paid by the customer, and the company's liability to account for the tax on this consideration could not be affected by an arrangement between the company and its employees under which part of the consideration was paid over to the employees.

The essential requirement in such cases is that there should be a direct link between the supply and the consideration which is given by the buyer. Furthermore, the payment whether it is payment in kind, money, or some form of a service should amount to consideration which has a monetary value.

3.3.4.2 ‘Course or Furtherance of an Enterprise’

The position in Lesotho is that a supply is taken to be made in the course or furtherance of an enterprise carried on by a vendor if the supply is made by the vendor as part of, or incidental to, any independent economic activity of the vendor, whatever the purposes or results of that activity.¹⁸⁴ This provision raises certain consequences. These are, firstly that the supply should be made as part of an independent economic activity or as part of a business. This means that a supply cannot consist of personal supplies or personal hobbies. In this way VAT is not to be charged where a supply relates to personal transactions and activities. Secondly, the purpose or result of the economic activity is irrelevant. What is relevant is whether there is an economic activity attached to the supply. Therefore, whether the economic activity resulted in either profit or loss, that is irrelevant to the question as to whether there is a supply or not.

There has not been any interpretation by the courts in Lesotho of what amounts to ‘carrying on an enterprise’. The decisions from South Africa and the UK can be examined for the purpose of interpreting the phrase as it appears in the Lesotho legislation, with the view that such decisions can be highly persuasive to the Courts in Lesotho. These decisions have in the same way been authoritative in interpreting a similar South African phrase - ‘carrying on enterprise’.¹⁸⁵ The SA VAT Act states that, ‘VAT is levied on the supply by any vendor of goods or services in the course or furtherance of any enterprise carried on by him’.¹⁸⁶ The general provision of the definition of “enterprise” includes any enterprise or activity which is carried on

¹⁸⁴ Section 12 (3), Lesotho VAT Act

¹⁸⁵ Jourbert, *The Law of South Africa*, paragraph 201 p.95

¹⁸⁶ Section 7(1) (1), SA VAT Act

continuously or regularly by any person in South Africa and in the course of which goods or services are supplied to any other person for a consideration, whether or not for profit.

The relevant South African decision where the meaning of 'enterprise' was considered is *Shell's Annandale Farm (Pty) Ltd v Commissioner, South African Revenue Service*¹⁸⁷ where the court referred to the definition of the word 'enterprise' in the Act, which provided that, 'VAT could only be levied in the event of a supply undertaken in the course of furtherance of any enterprise carried on by a vendor'. The court said that the definition highlighted the importance of some act on the part of the vendor prior to VAT being charged. Therefore, to answer the question whether there was an act by a vendor when its land was expropriated, the court held that the act of the authority to expropriate involved no act on the part of the person whose land was being expropriated. "The Expropriation Act 63 of 1975 made it clear that ownership of the property expropriated vested ipso jure in the expropriator as from the date of expropriation. Notwithstanding that the vendor dealt in land, therefore, it could not be envisaged that expropriation as defined by the courts could give rise to a supply in the course or furtherance of the enterprise carried on by the vendor."¹⁸⁸ The court made reference to the UK decision in *Oliver's case*.

Some recent UK decisions deal with the interpretation of the phrase "economic activity", which phrase appears in the EC Sixth Directive. *Article 4 (1)* provides that taxable person shall mean any person who independently carries out in any place any economic activity specified in *paragraph 2*, whatever the purpose or results of that

¹⁸⁷ 2000 (3) SA 564 - In this case the vendor was registered and conducted an enterprise as a lessor of agricultural land. The vendor received notification that the land it owned should be acquired for the establishment of low cost residential accommodation from the Provincial Administration. The vendor had initially rejected the Provincial Administration's offer but after further negotiations, the relevant property had been expropriated and the vendor was paid compensation and another sum as damages for mental compensation for the land. The South African Revenue Service subsequently claimed that the payment of VAT was due in respect of the amounts received by the vendor. The vendor denied that it was liable for VAT in respect of the compensation and the damages received for the expropriation of its property, since the expropriation of land did not involve any supply of goods or services under the VAT Act on his part.

¹⁸⁸ Davis, J., paragraph D-E p.575

activity. According to *paragraph 2* the economic activities shall comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income there from on a continuing basis shall also be considered an economic activity.

The UK VAT Act makes reference to the phrase ‘business activity’ and some of the courts decisions deal with the interpretation of this phrase. However, the EC phrase tends to be interpreted more widely than ‘business’ in the sense that the term tends to imply only profitable activities. Profit is irrelevant for the purposes of VAT, but some writers argue that profit motive is not necessarily irrelevant.¹⁸⁹ The argument is that the EC phrase of “economic activity” seems to refer to activities which are part of an economic enterprise and are profitable activities. However, profit should not necessarily be the determining factor. This means whether the economic activity does result in profit or not is not an important consideration. This leads to the conclusion that it is necessary to examine the intention of the business entity at the time the supply was being made, whether the entity had the motive to make profit from such a supply. This is regardless of whether the supply has indeed resulted in profit or not.

The interpretation of the EC ‘economic activity’ test was discussed in *ICAEW v Customs and Excise Commissioners*¹⁹⁰. On the basis of previous decisions of the ECJ,¹⁹¹ the Court held that for the purposes of the Directive the activities in question had to be of an economic nature and not simply consist of a supply of services in return for money. The court went further to say that it was not enough that the activities generated revenue for the Institute as this did not mean that they were economic activities. Therefore, it was held that the Institute’s regulatory activities could not be regarded as

¹⁸⁹ Williams, D., “Value Added Tax” op.cit. p.197

¹⁹⁰ [1999] HL 1 W.L.R 701 - the House of Lords had to decide whether the Institute of Chartered Accountants of England and Wales by providing regulatory services on behalf of the Government in respect of licensed insolvency practitioners was a “taxable person” for the purposes of the UK VAT Act s.4 and the Sixth Council Directive 77/388 Art.4. “Taxable person” was defined in Art. 2 of the Directive as a person carrying out an “economic activity”.

¹⁹¹ See *Polysar Investments Netherlands BV v Inspecie der Invoerrechten en Accijnzen Arnhem* (C60/90) [1993] S.T.C. 222, [1991] C.L.Y. 4146 and *SAT Fluggesellschaft mbH v European Organisation for the Safety of Air Navigation (Eurocontrol)* (C364/92) [1994] E.C.R. 1-43, [1994] C.L.Y. 4772

activities which possessed an economic character and it was not carrying on an economic activity.

This phrase was also considered in *Apple and Pear Development Council v Customs and Excise Commissioners*¹⁹² where the ECJ held that for a supply of services to be for consideration within *Article 2 (1)* of the EC Sixth Directive, there must be a direct link between the service provided and the consideration received. The court found out that on the evidence, there was no relationship between the level of the benefits which individual growers obtained from the Council's services and the amount of the mandatory charges which they were obliged to pay. It was held on the facts that the compulsory charges did not constitute 'consideration' and the Council was not making supplies of services for consideration. This case establishes the importance of the 'direct link' test between the supply and the (payment) consideration which is made.

Section 12 (4) of the Lesotho VAT Act identifies situations which will not be regarded as part of an enterprise. These include:- (a) in the case of an individual, any activities carried on by the individual as part of that individual's hobby or leisure activities and (b) in the case of any other person, any activities which if carried by an individual would come within paragraph (a). The two situations confirm the fact that activities which are carried out by an individual as personal supplies will be outside the scope of an enterprise. For example, if an individual (not in the car business) sells his own private car that is clearly for his own personal interest and is not in furtherance of an enterprise (no VAT is charged), while the sale of a car by a car dealer will qualify as

¹⁹² [1988] STC 221, 1988 2 All E.R. 922 - The Council was established in 1966 by a statutory instrument, with the principal object of promoting the sale of apples and pears in England and Wales. The Council comprised 14 members, appointed by the Minister for Agriculture, the majority of whom were growers nominated by the National Farmers Union. All commercial growers with two hectares or more, and 50 or more trees, had to register with it and pay a compulsory annual charge based on the area of their land to meet its expenses. Initially the Commissioners accepted that its activities were business activities on which it was entitled to reclaim input tax and that its compulsory charges to growers were outside the scope of VAT. In 1981 the Commissioners issued a subsequent ruling that its activities did not constitute a business and that it was not entitled to reclaim input tax. On appeal by the Council to the House of Lords, it held that an activity could only constitute a 'business' if it involved the making of taxable supplies for consideration, and referred the case to the ECJ.

in the course of an enterprise and be chargeable to VAT. More difficult questions might arise if a car dealer sold his personal car privately.

The difference in the use of terminology can be an indication that the use of the term differs from one jurisdiction to another depending on how either 'economic or business activity' or 'enterprise or taxable activity' is understood within each individual state.

These rules which have been discussed have to be considered in the context of whether the supply relates to goods or services. There are specific rules which can apply to either the supply of goods or the supply of services, whereas some rules are general in nature.

3.3.5 Mixed Supplies

Mixed supplies arise where a supply of goods also involves a supply of services. For example, where firm A providing internet services requires B to repair the computers and in the process B has to supply small parts to repair the computers. B charges A VAT for both the provision of the parts and the repair service. The question in this case is that in order to determine the VAT liability of these transactions, the first point to examine is whether there is a single supply or more; and second, whether it constitutes a supply of goods or services?

Mixed supplies can raise a number of issues particularly where the goods and services are subject to different VAT rates. It is therefore important to make a distinction between two situations which are raised by these kinds of supplies. First, there is a transaction which constitutes one single supply, even though it results in several benefits arising from the supply. In this case there is only one type of supply, either goods or services and it raises one VAT liability.

The *British Airways v Commissioners of Customs and Excise* CA¹⁹³ is a good example in this regard. The case was about whether the provision of meals to airline passengers represented a separate supply of catering services (which in the UK is subject to VAT in full) or whether it should be considered as a component of the supply of zero-rated transport services. The Tribunal held that the correct view is it should be considered as a component of the supply of the entire zero-rated transport services.

The case can be complicated further where a single supply results or requires two or more payments.¹⁹⁴ This decision demonstrates the point that though there are different payments which are made towards one supply, it does not change the character of the supply. It could be further argued that, the payments which are made should be directly linked to the supply.

The second situation is where there are multiple or mixed supplies. These occur where there are two or more different elements of supplies which raise different VAT liabilities. This can either be supplies of goods or services which are taxed differently, for example with one component being standard rated while the other is zero-rated. In these kinds of transactions the first question to ask is, what is the essential feature of the supply or what is the objective of the supply? The second question is what are the other related or ancillary features or features which do not constitute the objective of the supply and which are merely 'secondary' in nature? A supply must be regarded as ancillary to a principal supply if it does not constitute for customers an aim in itself, but a means of better enjoying the principal supply.¹⁹⁵ For example, if a telecommunication company (in Lesotho) supplies telephone calls which are taxed at a reduced rate of 5 per cent and also supplies telephone sets which are taxed at a standard rate of 15 per cent, the question which arises is whether a transaction which includes both the supply of a telephone set and telephone services by a telecommunication company would amount to

¹⁹³ [1990] STC 643

¹⁹⁴ For example, this was the case in *British Railways Board v Customs and Excise Commissioners* (CA, [1977] STC 221) where there were two payments, one for a student card allowing students to buy cut-price travel tickets, and the other which the student made when obtaining the actual ticket. The court held that the two payments were both for the supply of discounted travel paid at different stages, rather than for two separate supplies (of the right to a discount and then discounted travel).

¹⁹⁵ Laid down in *TP Madgett and RM Baldwin v Customs and Excise Commissioners*, CJEC [1998] STC 1189 (TVC 21.275)

one supply or more? The question is whether the supply of telephone sets is a component of the supply of telephone services (in particular telephone calls)? It can be argued in this case that the supply of telephone sets and telephone services by the telecommunication company are two separate principal services, in the sense that in order to supply telephone services, the company does not necessarily have to supply telephone sets to its customers. Therefore, these are two separate supplies and should be taxed separately.

Another issue which is likely to arise in Lesotho relates to cases where clothing retail shops issue their customers with a card which provides an easy monthly payment plan with a minimal service charge each month. In these situations interest is normally charged on the initial purchase price of the goods. This means the customer bears two charges each month towards the initial price of the goods, that is a service charge towards the maintenance and use of the card and interest charged on the price of the goods. The question that arises is does the provision of the monthly payment plan card and the provision of retail clothing by the shops constitute separate supplies or mixed supplies? One would submit that in this case, the use of the monthly payment card is not a principal supply, but it is merely ancillary to the supply of clothes to the customers.

Some of the controversies arising in this respect as to whether particular transactions constitute different elements of a supply or they are part of a single supply were discussed in the following cases: The CJEC in *Card Protection Plan Ltd v Customs and Excise Commissioners*¹⁹⁶, laid down a test to be used in considering whether a transaction constitutes one or more supplies:-

- where a transaction comprises a bundle of features and acts, regard must be had to all the circumstances in which the transaction takes place;
- every supply must be regarded as distinct and independent;

¹⁹⁶ CJEC [1999] STC 270 ECJ (Case C-349/96); [1999] ECR I-973 - In this case a card company insured credit card holders against loss but also kept a register of the cards and notified the credit companies if they were lost or stolen. The House of Lords ruled that it was important to determine the essential element of the supply, which in that case was the insurance. The other elements were identified as administrative and merely ancillary to the element of supplying insurance services. The House of Lords referred the case to the ECJ.

- a supply that comprises a single supply from an economic viewpoint should not be artificially split. The essential features of the transaction must be ascertained to decide if the customer receives several distinct principal services or a single service;
- there is a single supply in cases where one or more elements are to be regarded, by contrast, as ancillary services. An ancillary service is something that does not constitute for customers an aim in itself but is a means of better enjoying the principal service supplied;
- the fact that a single price is charged is not decisive; if the circumstances indicate that customers intended to purchase two or more distinct services, a single price will not prevent these being treated as separate supplies with different liabilities applying, if appropriate, to those services.

The ECJ emphasised in this case that: “There is a single supply in particular cases where one or more elements are to be regarded as constituting the principal service, whilst one or more elements are to be regarded, by contrast, as ancillary services which share the tax treatment of the principal service. A service must be regarded as ancillary to a principal service if it does not constitute for customers an end in itself, but means of better enjoying the principal purpose.”¹⁹⁷

The test was also applied in the following two UK decisions: - *Dr Beynon and Partners v Customs and Excise Commissioners*¹⁹⁸ and *Customs and Excise*

¹⁹⁷ Ibid at paragraph 30. The question which was referred to the ECJ was ‘whether a transaction which comprises several elements is to be regarded as a single supply or as two or more distinct supplies to be assessed separately?’

¹⁹⁸ [2003] S.T.C. 169 - In this case a GPs' practice appealed against a finding that drugs personally administered by doctors to patients under the *National Health Service ((Pharmaceutical Services) Regulations 1992 Reg.20* were exempt for VAT purposes. The issue on the appeal was whether the administration of drugs in such circumstances was a taxable supply so as to entitle the doctor to recover as input tax the VAT charged on the supply to him of the drugs. To determine that question the court had to consider whether the transaction in the course of which the drugs were administered was to be viewed as a single supply or as a number of distinct supplies. Customs argued that (1) there was a single supply, the principal service being the supply of medical care and the supply of the drugs being ancillary thereto, and (2) an injection of drugs was not a supply of drugs within the meaning of the VAT Act 1994 and the Sixth VAT Directive 77/388 Article 5, since it could not be described as a transfer of property. The Court allowing the appeal held that when drugs were administered to patients by doctors, there were at least two distinct supplies. They comprised, firstly, the diagnosis or medical consultation followed by the writing of the prescription and, secondly, the supply of the drug and, ancillary to that, its administration. The court

*Commissioners v Debenhams Retail Plc.*¹⁹⁹ In the latter case, the respondent retailer (D) had introduced a system in its stores under which customers paid by card signed a slip containing an agreement that 2.5 per cent of the value of the purchase was payable to an associated company for card handling services. Notices to that effect were displayed in D's stores. The card handling company was a subsidiary of D but was not of the same VAT group. D claimed that as a result it was chargeable to VAT on only 97.5 per cent of the purchase price of goods, since the balance of 2.5 per cent went to the card handling company as an exempt card handling fee. The Commissioners' two main contentions were that; first, there had been no contract for a supply of card handling services between the customer and the card handling company which affected the contract between D and the customer for the sale of the goods at the full purchase price; secondly, even if there was a contract between the card handling company and the customer, the commercial reality was that the card handling company provided no services and the customer provided no consideration.

Allowing the appeal by Customs, the court held that the important question is whether under the EU VAT Directives and the VAT Act 1994 there was a supply of goods or services for consideration. To be able to answer this question on the incidence of VAT, the court had to investigate the contractual effect of the arrangements between the parties. It found that the notification to customers in D's shops and at the point of sale and the till slip which the customer signed did not create a separate contract between the customer and the card handling company. This conclusion is supported by the use of a single ticket price in the stores and on both the retailer's and customer's copies of the till slip and by the difficulty identifying any consideration moving from the card handling company to the customer, since once the customer's card had been accepted at the till the transaction was complete as far as they were concerned. On this analysis the court concluded that, since there was only one contract between a customer

went further to say that the diagnosis or consultation was physically and economically dissociable from the supply and administration of the drug.

¹⁹⁹ CA (Civ Div) 18 July 2005

and D, D was to be treated as having made a supply for a consideration consisting of 100 per cent of the total paid by the customer.

This case also deals with the question, how to establish whether a transaction is chargeable to VAT or not. For a transaction to be chargeable to VAT, it should be established that there was a supply of goods or services for consideration. The link between the supply and the consideration should be clearly identified from the contractual arrangements between the parties.

The recent relevant decision in South African Courts on the status of a supply is the *Commissioner, South African Revenue Service v British Airways plc*²⁰⁰. British Airways plc is an international air carrier which operates aircraft to and from South Africa. It supplies zero-rated service (for international carriage) in terms of *section 11* of the VAT Act. Relying on the provisions of *section 8 (15)* of the VAT Act, which provided for taxation at different rates of parts of a single supply of goods or services, the Commissioner assessed for VAT at the standard rate one element only of the composite international fares paid by the British Airways' passengers during the relevant tax periods. This was the element which related to the passenger service charges which had been levied on British Airways by the company responsible for the operation of South Africa's airports.²⁰¹

The Court held that *section 8 (15)*, on which the Commissioner relied, applies to a single supply of goods or services comprising parts that would each, if they had been

²⁰⁰ 2005 (4) SA 231

²⁰¹ British Airways charges a fare to its passengers and that comprises an aggregate of various elements that are separately reflected on the passenger ticket. The bulk of the fare comprises an amount that is designed to recover its operating costs and its profit. The remainder of the fare comprises various smaller elements relating to a landing charge calculated with reference to the weight of the aircraft. This charge is levied every time that one of its aircraft arrives at a company airport. There are also landing charges which are calculated with reference to the length of time that their aircraft remains parked at a company airport. These charges are included by British Airways in its operating costs and are recovered as part of its operating costs. Another levy relates to a passenger service charge. This relates to compensate the company for the general airport services (baggage handling facilities, waiting lounges, check-in counters and the airport security) that it makes available to the passengers at its airports. This charge is directly related to the number of passengers on a flight. It is possible for the operator to recover it directly from each of the passengers. However, British Airways does that by reflecting the charge separately on the ticket as one of the elements that goes to make up the composite fare. It is in relation to this element that the Commissioner argued that British Airways was liable to pay VAT at the standard rate of 14 per cent. On the contrary British Airways contended that the element is part of its composite fare for the supply by it of international carriage, which is all zero-rated under the provisions of the Act.

supplied separately, have attracted a different rate of tax. However, on the facts, the supply of services to which the passenger service charge relates, are supplied by the airport operators and the tax accrues in terms of *section 7* (and is payable by the vendor of the service) when that supply occurs. The Court held that the moneys that are recovered by British Airways are not a consideration for the supply by it of airport services, simply because it does not supply them at all.

Similar cases will come up in Lesotho where traders supply different services which constitute one supply but have different elements within it. There will also be transactions which involve supplies which are taxable at different rates, though they may be related. The supplies can also involve services which are taxable at different rates. For example, most petrol stations, apart from making the supply of petrol have public payphones for their customers, while they will only pay a standing charge to the Telecommunications Company for the rental of the lines. Petrol is chargeable at the rate of 14 per cent while the supply of telephone calls attracts 5 per cent VAT. The question is whether the two supplies of services will be regarded as separate supplies or as a single supply with two elements? The other question which is crucial is which of these supplies represent the essential element of the supply? In this case, surely the supply of telephones will be treated separately from the supply of petrol. They amount to two different supplies of different types of services. Furthermore, some petrol stations also provide services of a regular check and general maintenance of motor vehicles while petrol is purchased. Can these services be regarded as a single transaction with multiple or separate supplies or can it be regarded as two transactions amounting to separate supplies? The test which can be applied is whether the supply of general maintenance of cars is an integral part of supplying petrol, or the other way round? The principal objective of the supply is to provide petrol and regular checking of oil, for example, in this case will be an ancillary objective.

In the UK similar cases have been decided where payphones were installed in launderettes.²⁰² In Lesotho, the legislation does not make a specific reference to what

²⁰² For example in *Chamberlain Domestic Services Ltd* (LON/93/27644A (12492)) a company which operated a number of launderettes installed payphones in the launderettes but did not account for output

constitutes mixed supplies and the principles which can be applied. Reference to mixed supplies only appears with respect to how the taxable value of each supply can be determined.²⁰³ However, these kind of supplies are likely to come up in Lesotho and some examples are referred to which are likely to face the revenue authorities.

The other relevant question which arises in relation to mixed supplies is what criteria can be used to determine the taxable value of each supply? *Regulation 3*²⁰⁴ provides the formula to be used in determining the taxable value of each supply in cases where there is a mixed supply. *Paragraph 2* deals with where there is a single supply of goods or services (referred to as the “primary supply”) which, if separate consideration had been payable, consist both of a supply charged at a positive rate and;-

- a supply charged to tax at a zero rate;
- a supply charged at a tax either at standard rate or reduced rate;
- an exempt supply

In such cases, each part of the supply shall be treated as a separate supply occurring at the same time of the primary supply (used to refer to a single supply of goods or services).

The applicable formula will be: $A \times B/C$

Where –

A is the total consideration for the primary supply;

B is the fair market value of the separate supply at the time of the supply; and

C is the sum of the fair market values of each separate supply at the time of the supply.

Though the formula exists for determining the taxable value of each supply, I would argue that the most crucial aspect is determining whether there are different or mixed supplies in one transaction or whether they constitute two supplies. This will require the facts of each case to be examined and the different tests which have been laid

tax on the receipts from these. The Commissioners issued an assessment charging tax on them and the tribunal dismissed the company’s appeal

²⁰³ Regulation 3 (2), Lesotho VAT Regulations 2003

²⁰⁴ Ibid

down by both the South African and the UK courts mixed or multiple supplies can be imported where they are relevant.

3.3.6 Place of Supply

The rules relating to the place of supply of either goods or services relate principally to the issue of establishing jurisdiction for charging VAT. VAT is a domestic consumption tax; therefore it should be confined within the jurisdiction of the country which imposes it. It is important to identify the place of supply in order to be able to determine whether a transaction involving a supply falls within the scope of a particular country. These rules appear in *section 10*.

A supply of goods occurs at the place where the goods are delivered or made available by the supplier or, if the delivery or making available involves the goods being transported, the place where the goods are when the transportation commences. The applicable rules do not take into consideration issues such as the time of supply, payment arrangements or the location of the parties. For example, if a sale of a car takes place in Lesotho and is delivered to an address in Lesotho but the car is then transported to South Africa, the place of supply is Lesotho where the car was delivered or made available by the supplier.

The general rule in Lesotho with respect to a supply of services is that the supply occurs at the place of business from which the services are supplied. However there are special rules which relate to particular services; whereby the supply of such services occurs where the recipient uses or obtains the advantage of the services. These include: - (1) a transfer or grant of a right to use a copyright, patent, licence, trademark or any similar right; (2) the service of a consultant, engineer, lawyer, architect or accountant, the processing of data or supplying of information; (3) an advertising service; (4) the toleration of any situation or the refraining from doing an act; (5) the supply of personnel; and a supply of electronic means.²⁰⁵

²⁰⁵ Section 10 (3), Lesotho VAT Act

There is also a provision for services which are regarded as supplied where they are physically carried out. These include the supply of cultural, artistic, sporting, and educational or services connected with movable property which occurs where the service is physically carried out. Similarly, a supply of services of transport (or incidental to transport) takes place where the transport occurs. These rules do not take into consideration the location of the customer or where the customer belongs.

The rationale behind the rule that the services are supplied where they are carried out is that the supply of the services concerned is not necessarily confined to a specific place or location. They can easily be supplied at different locations depending on where the service is required at a given time.

A supply of services in relation to immovable property occurs where the property is located. The legal recognition of the location of a supply of services relating to immovable property is supported by the fact that the benefits arising from immovable property can be enjoyed only where the property is situated and a customer can only use the services in relation to such property where it is located.

3.3.7 Input Tax

Input tax is defined as value added tax paid or payable in respect of a taxable supply to, or a taxable import by, any person, but does not include additional tax.²⁰⁶ A credit is allowed to any registered person for input tax paid or payable in respect of a taxable supply or taxable import in the course or furtherance of an enterprise carried on by such a vendor. According to the legislation in Lesotho, for input tax to be allowed, the following criteria should be met: - First, the person who claims the input tax must be a registered person. Second, the input tax must have been incurred in relation to a taxable supply or taxable import which was carried on in the course of furtherance of an enterprise. This means that input tax that is incurred in relation to activities which are

²⁰⁶ Section 3, Lesotho VAT Act. Additional Tax is not defined in the Act, however, it appears in Part VII of the Act which deals with Additional Tax and Offences. The term 'additional tax' in this context is payable where a person fails to apply for registration; to file returns; to maintain proper records; and

not directly related to the business or any economic activity in the business are not allowed under the legislation. Third, the input tax must have been tax paid or tax which is payable and fourth, a VAT invoice for the supply or a bill of entry or any other document prescribed under the Customs and Excise Act 1982 for importation of taxable goods should be available. There are cases where the Commissioner may allow input tax credit where the vendor does not have a VAT invoice as evidence for the input tax payable or paid in the tax period in which the credit arises. This is the case where the Commissioner is satisfied that;²⁰⁷

- the vendor took all reasonable steps to acquire a VAT invoice,
- the failure to acquire a VAT invoice was not the fault of the vendor
- the amount of input tax claimed by the vendor is correct.

The legislation also identifies cases where input tax credit is not allowed. This extends to tax on purchases of used goods; tax that is refundable to Diplomats, Contractors employed by the Government and other public international organisations; tax refundable under aid projects; and in relation to charitable activities. This restriction also extends to tax on purchases for non-commercial or passenger vehicles, entertainment representation and payments in kind to staff.

By way of an example, reference can be made to the South African legislation on the definition of 'input tax'. Input tax means²⁰⁸ "tax that is charged and payable by a supplier on the supply of goods or services made by that supplier to the vendor; or a person on the importation of goods by him; or a person in respect of the excise duty on certain manufactured goods."

Under the UK legislation²⁰⁹ input tax in relation to a taxable person, comprises VAT on goods and services supplied to him; on the acquisition of any goods by him from another EC country; and paid or payable by him on the importation of goods from outside the EC, provided the goods or services are used, or to be used, for the purpose of

where a person makes a false or misleading statements to a tax officer. In these situations additional tax will be payable over and above the VAT which is due.

²⁰⁷ Section 23 (5,) Lesotho VAT(Amendment) Act 2003

²⁰⁸ Section 1 (v), SA VAT Act

²⁰⁹ Section 24 (1), UK VAT Act

business carried on, or to be carried on by him. It has been argued ²¹⁰ that VAT paid does not become input tax simply because it has been incurred. It becomes input tax when it satisfies the other criteria and other legal requirements.

Where credit is claimed for input tax which was incurred in regard to a taxable supply which is partly for making taxable supplies and partly for private use by the vendor, the Commissioner will only allow credit for the amount of the input tax that relates to the making of taxable supplies. This principle is to safeguard the abuse of claiming of credit towards input tax which was not related to the commercial activities of the taxable supply, for example input tax incurred towards items for personal benefit or use. This also relates to the requirement of 'taxable supply' and the elements of consideration and enterprise as discussed earlier. Where goods or services supplied have been used for non-business purposes or non-commercial purposes, input tax is disallowed. This is related to the principle that VAT is chargeable on a taxable supply if it is incurred in the '*course or furtherance of a business*' carried on by the vendor. This principle is well summarised in *Apple and Pear Development Council*²¹¹ when Fox LJ said; "It seems to me that a person who conducts an activity in which he neither makes nor intends to make taxable supplies cannot claim credit for inputs in respect of that activity."

There are cases where it is not clear whether the input tax was indeed incurred for business purpose or non-business purpose. These kinds of cases will require the intervention of the courts to lay down tests or conditions which can be used as guidelines. For example, where a trader purchases a motor vehicle for the sole use of carrying out business activities, but in one particular instance he may use the vehicle to carry out his private activities. It will be very difficult in such a case to make a distinction between the two activities and to distinguish the input tax incurred. These kinds of cases have been dealt with in the UK and they are used as examples in this regard.

²¹⁰ Wareham, R., and Dolton, A., *Tolley's Value Added Tax*, 2003 op.cit. paragraph 35.1 p.653

²¹¹ [1988] STC 221 (CJEC)

In cases where the link between the expenditure and the business is not clear, the court in *Apple and Pear Development* laid the following tests: ²¹²(1) to determine the intention of the person at the time of incurring the expenditure (this is a subjective test of trying to examine the mind of the individual and this can be very difficult to prove. The court will have to resort to the evidence); and (2) to establish whether or not there is a clear connection between the actual or intended use of the goods or services and the activities of the business (this is an objective test of the use to which the goods or services are put).

These tests were applied in the Tribunal decision of *John Price Business Courses Ltd v Customs and Excise Commissioners*²¹³. The important principle which emerges from the relevant decisions is that where there is no clear link or connection between the expenditure and business, such expenditure cannot qualify as input tax incurred in the course of business or enterprise. Therefore, most countries have developed separate rules in order to make a distinction between input tax incurred for business activities and input tax incurred for non-business activities. According to McLellan²¹⁴ in VAT terms, “business means any continuing activity which is mainly concerned with making supplies to other persons for a consideration. The activity must have a degree of frequency and scale and be continued over a period of time”.

3.3.7.1 Non-Business Activities

Where a person engages in a non-business transaction or activity, he cannot claim VAT charged on the expenditures incurred. This can amount to private or personal activities which are clearly non-business by character or do not have any economic benefit in

²¹² [1988] STC 221 (CJEC) p.555

²¹³ [1995] VATTR 106 (VTD 5864) – In this case a company which supplied lecturing services reclaimed input tax on a subscription to a tennis club for its controlling director. The Commissioners rejected the claim on the ground that the expenditure had not been incurred for the purpose of the company’s business. The tribunal dismissed the company’s appeal, holding that ‘the expenditure was not directly referable to the purpose of the business’ and that it was not satisfied that the benefit of the company was ‘the real purpose in the mind of (the director)’ when he incurred the expenditure. The subscription was also described as a ‘luxury, amusement or entertainment’ activity.

²¹⁴ McLellan, *VAT: Input Tax Recovery* (Butterworths: London) 1993 p.27

addition. Many charity organisations, other non-profit making organisations and voluntary bodies engage in activities which are treated as having no economic value or no business element.

The leading case which can be used as an example from the UK in determining whether a supply was for business or non-business purposes is that of *Ian Flockton Developments Ltd v Customs and Excise Commissioners*²¹⁵. In this case the judge set out the test as follows: 'the test is, were the goods or services which were supplied to the taxpayer used or to be used for the purpose of any business carried on by him? The test is a subjective one: that is to say, the fact-finding Tribunal must look into the taxpayer's mind as it was at the relevant time to discover his object. Where the taxpayer is a company, the relevant mind or minds are those of the person or persons who control the company or are entitled to and do act for the company.'

This decision is said to conflict with an established principle relating to direct tax, where the House of Lords in *Mallalieu v Drummond* held that the conscious motive of the taxpayer at the time of expenditure is not conclusive.²¹⁶ These two decisions and the difference in the use of the tests under indirect and direct tax are significant. The question however is why the conscious motive of the taxpayer would be relevant in VAT while it was held not to be the case in income tax? This can depend in what context each case is being decided.

Furthermore in Lesotho input tax is not allowed, (1) where any supply or import by a taxable person is deemed not to be made with the sole purpose of furthering such a person's enterprise; (2) in respect of any claim for expenses incurred on subscription

²¹⁵ [1981] STC 394 - In this case a company which manufactured plastic storage tanks reclaimed input tax on the training and upkeep of a racehorse. The Commissioners issued an assessment to recover the tax and the company appealed, arguing that it had purchased the horse for promotional purposes. The principal director gave evidence that this was the sole object which he had in mind when he decided to buy the horse. The Tribunal upheld the assessment, accepting the director's evidence but holding that it should apply an objective test and that the company 'ought not to have had any commercial belief that the purchase and running of the racehorse could have been for the purpose of its business'. The QB allowed the company's appeal against the decision of the Tribunal, holding that the tribunal had been wrong to substitute an objective test for the test of what was actually in the mind of the witness at the time of the expenditure. Based on the facts found by the tribunal, the company's sole object in buying the horse was to promote its business.

²¹⁶ Wareham, R., and Dolton, A., *Tolley's VAT Cases* 1999 (Tolley Publishing: UK) paragraph 31.238 p.496, [1983] STC 665

fees of any sporting or recreational clubs; (3) where goods or services, for which input tax has been paid, have been in the possession of the vendor for a period exceeding 2 months prior to the date of registration.²¹⁷

It is also relevant to make a distinction with respect to input tax which is incurred for the 'purpose of the business' and one incurred for the 'benefit of the business'. Input tax which is incurred for the benefit of the business may not necessarily have been incurred for the purpose of the business. This means that input tax incurred for the benefit of the business does not mean that it was incurred for the purpose of the business, it could have been for another purpose. The relevant element is that the input tax should be incurred for the 'purpose of the business'.

This distinction was made in *Customs and Excise Commissioners v Rosner*²¹⁸ where VAT on legal costs incurred in defending a sole trader and director against criminal charges was held to be non-deductible, mainly because the expenditure was held to be for the benefit of the business, but not necessarily for the purpose of the business.

In Lesotho these kinds of cases are likely to come up. This can be in relation to vendors who rent out motor vehicles (vans or four-wheel drive mountain vehicles) to the government for various uses such as for use during construction of roads or to deliver goods or food to schools which are in the highlands of the country. During this time the government employees may be picked up or dropped off at their homes. The question that comes up is whether the picking up or dropping off the employees with a business vehicle, constitutes input tax that is incurred for the purpose of the business? There is no doubt it is incurred for the benefit of the business, to pick up the employees to ensure that they get to work on time, but can it be regarded as for the purpose of the business? In such a case it can be argued that input tax is incurred for the benefit of the government (a government is a taxable entity in Lesotho under VAT) and that benefit is directly related to the purpose of their specific supply. Therefore, in such cases it can be

²¹⁷ Regulation 10 (2), Lesotho VAT Regulations, 2003

²¹⁸ QBD 1993, [1994] STC 228

recommended that such an input tax should be allowed. However, such cases should be clearly examined and the necessary elements be clearly established.²¹⁹

3.3.7.2 Apportionment of Business and Non-Business Input Tax

Apportionment is part of the VAT law in a number of countries and it applies where input tax has been incurred for business and non-business purpose. The legislation in Lesotho does make provision for allowing an amount of input tax that relates to the vendor's taxable supplies, where a taxable supply (or import) is partly for the making of taxable supplies and partly for another use by the vendor.²²⁰ However, the legislation does not specifically mention the issue of apportionment as is the case in some countries. Reference can be made to the legislation of South Africa and Uganda as examples.

The SA VAT Act *section 16(3)* provides for apportionment of the full amount of VAT incurred by the vendor on the acquisition of the goods or services in order to determine what portion of that amount qualifies as input tax. In order to do this, the vendor needs to determine the proportion of taxable and non-taxable consumption or use of any goods or services. The South African Act in the same way as in Lesotho does not provide for a specific basis of apportionment, but does provide the different methods of apportionment which a vendor may adopt. A vendor is allowed to select any of the methods of apportionment, but in the case where he wishes to change from one method to another he has to get approval from the Commissioner. The methods of apportionment provided for are: - Input-based method, Turnover-based method, and Special methods.

The Input-based method calculates the proportion of the taxable use of goods or services by determining the ratio of VAT incurred on all goods or services which is

²¹⁹ For example, a similar situation arose in the *Renate Enkler* (Case C-230/94) where a German hired out her motor caravan, which she also used privately. Both the private use and hiring out took place in a short period of the year (the holiday season). In a period of two years, the motor caravan was hired out to two third party lessees for only a few days in total, and also to the husband of Mrs Enkler for a total of six weeks. The question was whether Enkler was a taxable person and whether he was performing any economic activities. It was held that Enkler was not performing economic activities.

²²⁰ Section 11(2), Lesotho VAT (Amendment)Act 2003

attributable to taxable supplies to the total VAT incurred on all goods and services during the tax period. The percentage thereof reflects the proportion of the taxable use of the goods or services which were partially attributed to making taxable supplies. The Turnover-based method calculates the proportion of the taxable use of goods or services by determining the ratio of the total value of taxable supplies, excluding VAT, to the total value of all supplies, excluding VAT, made during the tax period. The special methods can only be used where the Receiver of Revenue is satisfied that they will provide a fair and reasonable approximation of the actual use or consumption of goods for making taxable supplies.

The Ugandan VAT law also permits the right to claim input tax but with some restrictions. First, this is the case where, “goods and services have both a business and a private element (for example, business cars, business entertainment). The restriction applies where business and private use is not clearly distinguished. Second, there is a restriction where goods and services acquired for or produced by a trader are transferred to private use.”²²¹

*Lennartz v Finanzamt München III*²²² is a good example where the principle was discussed. The ECJ held in this case that the question of whether input tax was deductible was to be determined by reference to the capacity in which the purchaser of the goods was acting at the time of the purchase. Where goods are acquired purely for a private use, the tax incurred is not recoverable, even if the goods are put to a deductible business use at a later stage. However, if the goods are later sold to a taxable person no VAT is chargeable, as the vendor is not acting as a taxable person. Where a taxable

²²¹Bakibinga, D.J., “The Introduction of VAT in Uganda: Avoiding the Great Ghanaian Debacle” *VAT Monitor* 1996 Vol. 7 No.2 pp58-66 p.60

²²² C-97/90 [1991] STI 700 ECJ - The case concerned a German taxpayer, who bought a car in 1985 when he was working partly as a self-employed tax consultant. At that time he used the car only to a very limited extent for his own business, about 8 percent of total use. The German tax authorities have no input tax restriction covering cars – for input tax purposes cars are treated in exactly the same way as other business assets without tax being due on any private use. They do, however, operate a de minimis limit, whereby business use is ignored when it is less than 10 percent of total use. As a result, the taxpayer was unable to recover any VAT incurred on the purchase of the car. When his business activities expanded, he claimed an input tax deduction of the tax paid on buying the car. The German tax authorities decided that he had initially bought the car wholly for private use and denied him the deduction. The matter was then referred to the ECJ.

person acquires goods and uses them partly for the purposes of his taxable supplies and partly for private (or non-business) purposes, he has a right to total and immediate input tax deduction. Furthermore, where the goods are later used for private or non-business purposes, that use is to be treated as a taxable supply of services and VAT must be accounted for under the relevant VAT provision.

The principle of apportionment of input tax is likely to be imported to decide cases in this area in Lesotho. The courts in Lesotho are likely to adopt the SA approach which has been mentioned above in determining the tax liability where a supply has been partly for business and partly for private purposes. However as regards which methods of apportionment should be adopted in the VAT system in Lesotho, it seems that the various methods in South Africa are also not absolute, in the sense that the Receiver of Revenue has the right to grant permission to use other special methods. Therefore, I would recommend that the Commissioner will have to recommend the use of methods of apportionment which are easy to understand and which will result in fair and reasonable approximation of what actually amounts to the use of the goods or consumption of services for making taxable supplies. It would be appropriate to consider the nature of registered vendors in developing these kinds of methods to ensure that they will be able to apprehend them and apply them correctly.

The other important issue which needs to be considered is whether input tax can be reclaimed in respect of stolen goods.²²³ On the basis of the decision in *CR Hudson*, it can be argued that the Court was influenced by the fact that the goods were repossessed later by the police. If fiscal neutrality demands that a supply of stolen goods by the thief constitutes a supply, it seems rather unfair that input tax cannot be recovered in respect of stolen goods whereas VAT is charged accordingly. On the other hand, the law would not uphold a transaction which involved illegal goods. I think the courts should not look beyond the transaction and the requirements of VAT.

²²³ For example in the UK case of *CR Hudson (t/a 21st Century Demolition and PlantHire)* (MAN/91/1016 (9666)) a demolition contractor reclaimed input tax in respect of the purchase of an item of equipment which had been stolen. The item was later repossessed by the police and returned to its rightful owner. The

3.3.7.3 When to claim Input Tax

Input tax can be claimed during the tax period when the vendor has submitted a VAT invoice or a bill of entry or other document prescribed under the Customs and Excise Act, for imported goods and services.²²⁴ The law also provides that input tax should be claimed on the VAT return for the period in which the VAT became chargeable

In some countries, there is a time limit for late claims towards credit of input tax. For example, in the UK with effect from 1997,²²⁵ input tax cannot be claimed more than three years after the date by which the return for the period in which the VAT was chargeable is required to be made. The Lesotho legislation is silent about the time limit for late claims. One wonders how late claims will be dealt with. The most likely approach is for the Commissioners to use their discretionary powers to decide which late claims can be accepted and which ones are not accepted. This is an important omission and the taxable persons are likely to be prejudiced by this omission.

3.3.8 Registration of Taxable Person

The VAT law in Lesotho use the term 'vendor' to refer to a person who is, or is treated as, registered for purposes of VAT. Every taxable person, (a person who makes a taxable supply) who is not already registered is required to apply to be registered as a vendor. Registration is an integral part of the VAT system, since only registered traders are liable for VAT and are part of the system. Any person who carries on an enterprise and makes an annual turnover of M500, 000 (Five Hundred Thousand *Maloti*) per annum is required to register for the purposes of VAT.²²⁶ For a person to register they must be

Commissioners issued an assessment to recover the tax and the tribunal dismissed the contractor's appeal, holding that there was no right to reclaim input tax in respect of stolen goods.

²²⁴ Section 11 (4), Lesotho VAT (Amendment) Act

²²⁵ Section 25, UK VATA 1994

²²⁶ The law provides for an option for voluntary registration for any person who is not required to register. *Section 17 (5)* provides; "a person who supplies goods or services for consideration in the course or furtherance of an enterprise carried on by that person and is not required to register may apply to the Commissioner to be registered". This principle of voluntary registration is discussed in detail in chapter 5 in the context of small businesses in Lesotho.

making taxable supplies in the course of an enterprise. Therefore, even traders whose supplies are excluded from VAT through zero-rating must be registered. (This is because although their supplies are zero-rated they do make 'taxable supplies in the course of a business' and therefore meet the criteria for registration).

A vendor as defined by the legislation must be a "person" in order to qualify for registration. The concept of "person"²²⁷ is used as a legal term to include all legal entities such as a partnership, company, trust, government, political subdivision of a government or public international organisation, charities and clubs, which have a separate legal personality and which are engaged in economic activities. The definition of 'person' differs from country to country depending on which entities have a separate juridical personality.

The other requirement is that the vendor must be making supplies made in the course or furtherance of an enterprise. This is interpreted to mean that the taxable unit is not an enterprise as such, but the enterprise is the person who conducts the enterprise.²²⁸ This is why where a person operates more than one business even though they are not similar, all the person's business activities must be covered by one registration. This one registration relates to the person who conducts the businesses and not the businesses themselves. *Section 17 (4)* of the Lesotho Act contains a similar principle. It provides that, in determining whether the registration threshold is exceeded, regard shall be had to the value of all taxable supplies made by the person and associates of the person. This means that in this case even the small or medium business entities which if considered on their own would not be above the minimum threshold would form part of the value of the collective taxable supplies of the vendor.

Similarly under the South African law every person who carries on an enterprise is required to register if he makes a certain amount of taxable supplies.²²⁹ This SA provision also endorses the fact that it is a vendor who is required to register for purposes of VAT, and not the enterprise. Two consequences will flow from this

²²⁷ Section 3, Lesotho VAT Act

²²⁸ Jourbert, *The Law of South Africa*, op.cit. p.94

²²⁹ S.1 (v), SA VAT Act

principle²³⁰: - Firstly, a person is entitled to only one registration despite having enterprises with different branches or divisions. Secondly, a person's registration covers all his business activities, however wide or diverse they may be. This means that taxable supplies from all the enterprises carried on are taken into account in determining whether or not a person is liable to register. Separate registration is practical and possible with companies (and large organisations) if they have different divisions or units which make supplies in their own right from the company itself. This effectively means that where a division of a company is making taxable supplies which are chargeable to VAT, that division can register separately and this obligation does not extend to the other divisions. Therefore, any supplies made by the registered division to other divisions or units of the company are subject to VAT and this will be the case even if one of the businesses on its own falls below the minimum threshold.

This principle of registration underlies the basic requirement to charge VAT. It is only a registered person who is entitled to charge VAT on goods and services, and to pay the tax to the revenue department. It would be logical to say that if an unregistered person charges VAT, the Commissioner can oblige the trader to make such payments of VAT to the revenue office.

The Lesotho legislation requires that a person who carries on an enterprise outside of Lesotho but whose goods or services are consumed in Lesotho should apply for registration irrespective of whether such a person meets the threshold. Registration under this provision²³¹ is renewable annually, at the expiry of the last registration date. This provision introduces a novel practice of a vendor who is required to be registered though the vendor does not carry any enterprise within the country. The requirement to register in this respect arises from the consumption of goods or services of the vendor.

There are questions which arise from this provision, especially if the supply relates to services. It can be difficult for the Commissioner to prove that the person has provided services such as making repairs of, (for example) computers, photocopiers and fax machines or internet services in Lesotho. It will be to the benefit of the buyer, if he is

²³⁰ Jourbert, *The Law of South Africa*, op.cit. p.179

²³¹ Section 17 (6), amended by Section 9 (6) (b), Lesotho VAT (Amendment) Act, 2003

a registered trader and may wish to claim input tax from the supplies of services with the computers, photocopiers and fax machines. The seller has to provide an invoice, but cannot charge VAT to the seller if he is not registered in Lesotho. In respect of goods, since they have to be checked at the border posts at the time of importation, the customs officials will require payment of VAT or proof of payment of VAT and in that case, the person importing the goods will wish to recover the VAT from the customers to enable him to claim any input tax which arises. In such circumstances, therefore, the person will be obliged to register.

A person who has been registered by the Commissioner is issued with a registration certificate. In accordance with *section 17 (9)* the registration certificate states the details which identify the registered vendor and the name of the vendor; the nature of the vendor's trading activities; the date on which the registration takes effect; the taxpayer identification number of the vendor; the physical address of the vendor's trading firm and any other matters which the Commissioner may wish to include. The underlying importance of the registration certificate is to lay out the details of the vendor which identify the person in all their taxable matters with the revenue authorities.

The Commissioner has the right under *section 17 (13)* to impose conditions or limitations on a registration of a vendor. This right also extends to suspending or modifying the conditions on a registration. The provision does not specify the circumstances when the Commissioner can exercise this right. One would presume that the Commissioner is likely to exercise this right in relation to a vendor who might have defaulted in fulfilling his tax obligations under the sales tax system. This right can also be exercised by the Commissioner in relation to the registration of a vendor who at the time of registration falls below the threshold, but is likely to reach the minimum threshold in one or two years of registration. Furthermore, where the vendor has voluntarily registered and is not obliged to register, the Commissioner may wish to impose conditions in relation to that particular registration in relation to when to file returns and make payment of tax.

Furthermore, *section 18* of the VAT Act allows a vendor to apply for cancellation of registration where the vendor has ceased to make taxable supplies.

Furthermore, the Commissioner is given the power to cancel the registration of a vendor who registered voluntarily under the VAT Act under the following circumstances: -²³² where the vendor has not kept proper accounting records relating to any enterprise carried on by the vendor; has not submitted regular and reliable VAT returns as required by the Act; has no fixed place of business; and where the vendor is not, in the opinion of the Commissioner a fit and proper person to be registered.

The Commissioner is obliged to inform the vendor of a decision to cancel or to refuse to cancel a registration within fourteen days of making the decision. This provision will apply where the vendor is the one who applied through his own initiative. The Commissioner is likely to refuse an application to cancel a registration where he needs to undertake further investigation on the status of the vendor's enterprise (whether indeed he has stopped making taxable supplies or whether the value of his taxable supplies has indeed fallen below the threshold). The Commissioner has to rely on the investigations to be carried out by the inspectors through site visits and examine the audit reports, accounting reports and tax reports of the vendor. In this way the Commissioner will ensure that the vendor who has made an application is indeed genuine and indeed qualifies under the provisions of the Act to be deregistered.

Where the Commissioner has granted cancellation of registration, it takes effect from the date specified in the notice of cancellation. The consequences of deregistration are that; the vendor is treated as having made a taxable supply equal to the fair market value of all goods which he still retains (including raw materials) at the date the registration is cancelled. This will only apply if an input tax credit was claimed with respect to the goods. This provision tends to safeguard the interests of the administration and avoid the situation where a vendor claims an input tax deduction in respect of transactions which were completed while the cancellation application was being considered by the Commissioner. Moreover, even where deregistration has been granted, the person is liable for all the obligations and liabilities arising out of transactions which occurred while the person was registered as a vendor. These include the filing of returns and payment of tax if such obligations are outstanding from that time. However, in cases

²³² Section 18 (6), Lesotho VAT Act

where all these have been met and fulfilled, the person whose registration has been cancelled is no longer a vendor for the purposes of VAT and is relieved from any obligations arising thereof.

The principle of registration of taxable persons raises three challenges to VAT. First, this principle assumes that there is compulsory registration and optional registration. This means small businesses are given a choice as to whether they want to register or not. Second, there is a possibility of false disclosure of all the businesses which are obliged to register as a way to avoid registration and liability for VAT. Third, some businesses may overstate their business activities and their turnover, aiming to claim credit for input tax while accounting for VAT and the other advantages of being registered, which include improved record keeping skills.

3.3.8.1 Persons liable to pay tax

Any VAT payable in the case of a taxable supply has to be accounted for by the vendor who is making the supply; while in the case of a taxable import the importer is liable for the tax payable. The government and its related entities are also liable to pay VAT if they engage either in a taxable supply or import goods or services according to *section 7 (2)*. The provision does not specify to what extent the VAT law binds the government. It can be concluded that the government is obliged to pay VAT on all its taxable supplies of goods and services.

The implementation of this requirement is likely to raise challenges to VAT in the sense that it is not easy to get the government to pay tax. This is the case particularly if under the previous tax system the government was not required to register and charge tax. In most cases, the government is likely to delay making payments of the tax to the revenue office. This creates administration difficulties in enforcing compliance to avoid the problem where other taxable persons may also delay payment of the tax.

In practice those countries which include the government and other public sector bodies within the VAT net do not tax activities that are performed in the exercise of their public authority. New Zealand is an example where the public sector bodies are taxed

generally, 'except where they make exempt supplies.'²³³ This entitles a government department to charge VAT on its supplies. The authorities in New Zealand have supported this approach and believe that, "the registration and payment of VAT by public sector bodies increases the accountability and transparency of government operations'.²³⁴

In Lesotho, the inclusion of government within the VAT system is justified on grounds of avoiding opportunities for abuse by individuals (government employees) to use the government purchasing machinery to obtain goods (such as petrol from the government station) and to acquire other benefits for their own private use. Further, it was recognised that the government departments in some cases are engaging in similar activities as the private sector and yet they were not taxed under sales tax. This in a way created distortions between the private sector and the government departments which engage in activities which are taxable. For example the Public Works department (government department) undertakes construction of roads and schools and obtains consideration; therefore the department has to account for the tax in such transactions.

The inclusion of public sector bodies within the VAT base seems to be a better approach to deal with these bodies. This is an effective way to ensure that the public sector bodies do not compete with the private sector in offering services and yet are treated favourably under the VAT system.

3.3.9 Rates of VAT

The Lesotho VAT structure consists of the following rates; (1) the basic rate of 14 per cent for all taxable supplies and services; (2) a higher rate of 15 per cent in the case of import and supplies of alcoholic beverages and tobacco; (3) a reduced rate of 5 per cent for supplies of electricity and telephone calls; and (4) a zero-rate in the case of supplies listed in *Schedule IV* in terms of *section 6A* of the VAT (Amendment) Act and in the case of exports.

²³³ Cnossen, S., "Global Trends and Issues in Value Added Taxation" op.cit. p.403

²³⁴ Ibid

Though the IMF team in Lesotho had favoured the adoption of a single VAT rate and a zero rate for exports, Lesotho is also guided by its obligations under SACU membership. The SACU Agreement prevents member countries from setting their own excise tax rates on products such as alcoholic beverages and tobacco products, and therefore this can provide justification for setting a VAT (or sales tax) rate which is higher than the standard rate on those products. In most cases the higher rate is imposed on goods which are usually referred to as 'luxury' goods, which are mostly consumed and used by high income households. The IMF however, failed to find a justification for introducing a reduced rate of 5 per cent for electricity and telecommunications. One can simply speculate that the reason for introducing a reduced rate for electricity and telecommunications is that the authorities classified them as essential especially in the modern developing economy rather than a basic economy. Therefore as a way to encourage the use of the services even by the low (and middle) income earning households and to alleviate the tax burden on them, they settled for a reduced rate on these services, despite the fact that they are mainly enjoyed by the rich. Therefore, the authorities had to ensure that they achieve progressivity in taxing those services.

VAT rates differ in each country since they are influenced by different factors which exist within each country. The VAT rates depend on the existing state of the economy and the tax system and the fiscal policies also dictate the number of rates each country wishes to adopt. The differences in the approach towards VAT rates can be seen from the different standard rates which have been adopted in Sub-Saharan countries as it appears in Table 1.

In most countries practice has shown that the consumption patterns of the different groups in society are different. Therefore, introducing lower rates on particular items (in particular food) in these countries does not necessarily result in tax relief only for the lower income earning groups, but the middle and higher income earners benefit to a greater extent. This is more apparent in developing countries, since the lower income earners in these countries tend to purchase most of their goods and food from local small traders, who are mostly below the registration threshold. In practice it can be difficult for the revenue inspectors to monitor some of these small local shops and to

regulate prices at which they sell. The higher income earners in Lesotho, for example, mostly tend to buy their goods from big wholesalers or even import them from other countries and this enables the revenue officers to impose tax more effectively in such cases.

As far as Lesotho is concerned, a reduced rate on electricity and telephone calls is certainly important. The reduced rate on electricity and telephone facilities does benefit the middle income earners and the high income earners mostly. The reason is that the consumers from those categories are the ones who have access to the facilities which provide electricity and telephones. There are some parts of the country where these facilities do not exist at all and for some people installation to access the facilities is costly. Therefore, in such cases the low income earners do not necessarily gain from the reduced rate of such supplies.

The use of multiple rates in Lesotho, as in other countries, will create the problem of classifying the different items in order to distinguish them according to rates. The use of multiple rates poses both administrative and legal difficulties, in the sense that the regulations have to be specific in defining the products to achieve a clear distinction in their categorisation. This has the potential to lead to complicated legal provisions. For example, maize meal is zero-rated to the extent that it is graded as super maize meal, special maize meal, sifted maize meal or unsifted maize meal.²³⁵ This means where a business entity also supplies maize meal which does not fall within the zero-rated classification which is mainly 'crushed' maize meal but falls outside the above classification, this will be classified as standard rated. This requires the administration to be precise in the classification and maintaining such a system can be time consuming and expensive. This will require detailed administrative procedures and resources to enforce them. Therefore, there will be a need for inspectors and auditors to pay attention to ensure that retailers have divided the items accordingly in terms of the applicable rates. This can also be complicated for the business entities.

²³⁵ Regulation 21 (2), Lesotho VAT Tax Regulations, 2003

Furthermore, this can result in the legal complexity of the system, in the sense that the law has to provide definitions at all times where a distinction between commodities is made. This will lead to provisions which are complicated and confusing to the taxpayers and the administration.

Apart from the administrative problems, the introduction of multiple rates will also result in distortions in cases where commodities can be easily substituted and such substitutes are taxed at very different rates. In such a case the consumers' choice will be distorted between the goods.

3.3.10 Reliefs from VAT: Exemption and Zero-Rating

Like most VAT systems, particularly in developing countries, the Lesotho VAT system provides for reliefs from tax in the form of zero-rating and exemption. This chapter highlights the law in Lesotho on zero-rating and exemption. The discussion sets out what items and sectors are zero-rated and exempted and critically analyses the problems which are likely to arise. In the case of Lesotho, the government has chosen to zero-rate some goods which are identified as basic, particularly to the low income earners. VAT in this case is used to relieve the burden of taxation on those items which are regarded as necessities. This was to ensure that the distributional impact of VAT does not bear heavily on the poor in respect of those goods and items which are mainly basic to their daily living, such as paraffin and maize meal. However, it is important to note that though the intention of the government was to relieve tax for the low income earners, it seems in practice both the high income earners and the low income earners benefit from the exclusions in the same way.

Furthermore, the provision of exclusions under the VAT system in Lesotho is likely to have been influenced by the position in South Africa. The government had to ensure that to some extent it zero-rates similar goods and items as the ones which are zero-rated in South Africa in order to reduce the smuggling of goods across the border.

However, there are still differences between Lesotho and South Africa on goods which are zero-rated.²³⁶

3.3.10.1 Zero –Rating

Zero-rating is applied on the export of goods or services from Lesotho and the supply of certain goods (which are specified) and services. Zero-rated supplies are effectively chargeable to VAT, but the VAT is zero. The supply is regarded as a taxable supply though it gives rise to a zero rate. *Section 6 (5)* VAT Act provides that supplies of goods or services are zero-rated only if they are specifically mentioned as being zero-rated.

It is clear from this provision that for supplies of goods and services to be zero-rated they have to be specifically mentioned in the relevant section and Schedule dealing with zero-ratings, otherwise all taxable supplies which are not zero-rated are subject to tax at the standard rate. This provision tries to ensure that there is no speculation about what is zero-rated or not, as this could cause unintended confusion in relation to the supply of goods and services.

Zero-rating in Lesotho is restricted to basic foodstuffs and supplies which can be regarded as basic necessities. These goods and items are listed in *Schedule IV* of the Act and *Part XI* of the Regulations. These include, beans, bread, maize (grain) and maize meal, milk, paraffin (which is intended for use as fuel for cooking, heating or lighting), wheat (grain) and wheat flour, peas, sorghum meal, unmalted sorghum grain, agricultural related products – fertilizers, seeds and pesticides; livestock feed and poultry feed. These goods are zero-rated for social reasons. They are regarded as supplies which are basic and social in nature. The rationale behind zero-rating such items is to protect the low income earners against the market inequalities of rising prices and so that they are able to access basic foodstuffs and other items. Paraffin is a major source of energy for low-income households, for cooking, heating and lighting.

The zero rating in respect of beans and peas extends only to dried beans or peas, but not ones which are further processed or prepared or where they are packaged to be

²³⁶ See chapter 4 for a detailed discussion on this point

used as seed. This means beans or peas in cans, frozen and fresh ones are not zero rated. Similarly, those which are packaged as seed despite the fact that they are dried are not zero rated. Therefore, controversy will arise in respect of supplying beans or peas which are packaged as seed in other forms or for purposes of consumption. The distinction is in the use and the form in which they are supplied. This means that business entities that are caterers and supply beans in soup or cooked beans or peas in any form cannot be allowed to zero rate such items.

Maize is zero rated to the extent that it is dried maize or dried seed of the maize but this excludes pop corn or green mealies for human consumption. This means that canned corn (maize) and fresh maize are not zero-rated. This is a fine distinction particularly if we consider the use of maize. It seems the intention of the government was to extend zero-rating only to dried maize. The reason for zero-rating maize is that it is the staple food and also forms part of the basic necessities in Lesotho. Therefore, this was intended to allow the low income households to be able to purchase this product.

Zero rating also extends to milk and bread to the extent that these products are intended for domestic consumption. This means the use of bread and milk for use in the restaurants and cafes is not zero rated. For example, the sale of sandwiches by a caterer or food retailer for lunch cannot be regarded as zero rated, since it is only zero rated when it is for domestic consumption. This is an area where controversy is likely to arise. For example, if a baker supplies bread to both caterers and consumers, the supply of bread to the consumer for domestic consumption is zero rated. The question is how is the baker going to know whether the bread sold to the caterer is for domestic consumption or for use in the catering shop? It seems the important distinction is in the end use of the goods, which are the bread and the milk.

In certain situations it can be difficult to determine when supplies are zero rated and when they are not. The burden of proof lies with the business entity to prove that that the supplies or the items qualify for zero rating.

3.3.10.2 Exemptions

Exemptions are another way to provide relief from VAT. Exempted supplies in Lesotho are provided by *section 6* of the Act (as amended by *section 4* of the Amendment Act) and *Regulations 17, 18, 19, and 20*. These exempted supplies are: - firstly, financial services, insurance services, education services, public postal services, transportation services and medical and dental services; secondly, supplies of unimproved land (this is significant since under sales tax, a supply of unimproved land was taxable at the rate of 10 per cent); thirdly, supplies by way of lease or letting of immovable property; and fourthly, supplies of water are also part of the exempt supplies.

The various services which are exempted are defined and restricted within what the legislation provides. Financial services are restricted to granting, negotiating and dealing with loans, credit guarantees and security for money. It also includes transactions concerning deposit and current accounts, payments and transfers, debts, cheques and other negotiable instruments. Transactions relating to shares, stocks, bonds and other securities and management of funds are part of the exempted financial services.

Education services means education provided by a pre-primary, primary, secondary school, a college or a university. It also covers any institution which is established for the promotion of adult education, vocational training, technical education and the education or training of physically or mentally handicapped persons. For an institution to qualify for exemption it should be registered with the Ministry of Education for the exemption to apply. It can be argued that any other type of training or the provision of short courses is subject to VAT. For example, where a University or a registered institution runs a scheme of short courses during specific periods over the year on different specialised subjects, it can be argued that the supply of such services does not constitute education services in terms of the provision. The provision of specialised ad hoc courses does not necessarily constitute education services, unless this can be regarded as part of technical education.

An exemption also applies in respect of the supply of transportation services of fare-paying passengers and their personal effects by road. The exemption is restricted to transport by road, since that is the most common and affordable means of transport in Lesotho, in the absence of trains.

The exemption of the supply of unimproved land is a significant relief from tax to the consumers, as this encourages the acquisition of land mainly for purposes of building houses. This was not provided for under the sales tax and consumers were discouraged from acquiring land, particularly the poor, who were forced to rent property. This exemption in a way relieves the burden of tax not only from the low income households, because high income households will benefit too.

3.3.11 Accounting for VAT: Tax Period and Returns

3.3.11.1 Tax Period

The accounting procedures for VAT in Lesotho depend on the period of filing of a tax return by the vendor. In terms of *section 27 (1)* of the VAT Act, a vendor is required to file a VAT return for each tax period within twenty eight days after the end of the appropriate period. This period is referred to as a tax period. A tax period under the Lesotho VAT system means “the period of one month ending on the last day of each of the twelve months of the calendar year”.²³⁷ This means that tax returns are filed monthly by the vendors within the prescribed period. This can be an effective way to monitor the level of compliance particularly where VAT has just been introduced. This ensures that the tax administration is able to check the effectiveness of the filing process and to easily determine those vendors that are failing to comply. However, on the other hand, it can be argued that the fact that the tax period is one month tends to generate an administrative burden of checking and monitoring tax returns while the administration could be dealing with other issues of the system such as the processing of refunds and

²³⁷ Section 3, Lesotho VAT Act

carrying out inspection site visits to the vendors. This is one of the issues which the administration needs to review after a reasonable time of implementing the tax.

The VAT return is submitted on a prescribed form which the revenue authorities give out to the registered traders at the end of a tax period. It should stipulate clearly the amount of VAT to be paid by the vendor (if any) for the period to which the return relates.

It is not a requirement that every tax return should be accompanied by a tax invoice, however where the revenue authorities wish to refer to the invoices and inspect them, the vendor is obliged to make them available to them. This is likely to be the case where the vendor is either an exporter and has to be refunded or where a vendor is claiming a tax credit or supplies zero-rated goods.

3.3.11.2 Time of Supply

The other important principle for accounting is the ‘time of supply’. This is referred to as a ‘tax point’ under VAT and it determines the time when the supply is actually made. The tax point is also relevant for establishing the time when VAT is charged on a supply and this helps in determining when VAT becomes payable. VAT becomes payable during the tax period when it was charged and became due. The rate to be applied to the tax will depend on the rate which is applicable at the time. The basic principle to determine the time when a supply occurs is laid down in *section 9* of the VAT Act. The time of supply is the earliest of, (a) the date on which the goods are delivered or made available or the performance of the services is completed; (b) the date on which the invoice for the supply is issued; (c) or the date on which payment (including part payment) is made.

Apart from the basic tax point rules which are provided, the Lesotho legislation also refers to specific tax points relating to particular supplies, for example, where goods are supplied by auction, the time of supply will be on the date of the auction or where the goods or services are supplied by way of gift, the time of supply will be on the date on which ownership in the goods passes or the performance of the services is completed.

3.3.12 Administration

The general administration and implementation of VAT lies with the Commissioner-General (the Commissioner). The Commissioner is entrusted with the responsibility to collect, enforce, recover and administer VAT (and other indirect and direct taxes) and to appoint the Commissioner of VAT. The Commissioner also has the responsibility of monitoring the filing of returns every month from taxable persons. Where a person fails to file a return for each tax period, or the Commissioner is not satisfied with a return filed by a person; or has reasonable grounds to believe that a person will become liable to pay VAT under the Act but is unlikely to pay the amount due, the Commissioner is given the power to make an assessment of the amount of VAT payable by that person. The Commissioner may also estimate the VAT based on the information available for making an assessment.

The administration of VAT most importantly involves registration of vendors and monitoring of the filing of tax returns, which includes payment of VAT to the revenue authorities. A vendor is required to file a VAT return at the end of each tax period and VAT is payable on the date when the return is to be filed. This means the tax return and the VAT payable are due on the same date, except if an assessment is made by the Commissioner. The administration has to monitor that tax which is collected from customers and other registered business entities is paid over to the government. It is the duty of the registered vendor to collect VAT on behalf of the government and pay it over when it is due. Reference can be made to a judicial decision in South Africa, where failure to pay collected VAT to SARS in contravention of the provisions of the VAT Act was held to constitute an offence involving dishonesty.²³⁸ The court confirmed that levying and receiving of VAT for any purpose other than paying it to the government in accordance with the statute is inherently dishonest.

²³⁸ In *Estate Agency Affairs Board v McLaggan and Another* (2005 (4) SA 531) the Court on appeal had to decide whether offences in respect of which an estate agent was convicted in 2002 under both the Income Tax Act 58 of 1962 and the Value Added Tax Act 89 of 1991 involved an element of dishonesty such that his fidelity fund certificate lapsed or should be withdrawn. (For purposes of the discussions in this part, reference is made only to the part of the judgement that deals with VAT.) The estate agent had been levying VAT accordingly on the supply of his services, but had failed to pay the tax over to SARS

A more preferred approach in dealing with some of these problems is that the administration commits resources to carry out thorough checks of tax returns and claims for tax refunds. This is to guard against fraudulent returns and refund claims as well as to ensure that genuine invoices accompany the refund claims.

The Commissioner should be able to regulate the payments of the tax. This will ensure that VAT which is payable by the businesses is indeed paid when it is due, in order to balance that with the payment of refunds which has to be made out to traders. The money that comes into the 'government revenue pool' is basically used to meet the claims for refunds. This means the Commissioner can also put a mechanism in place to ensure that the refund system does not exceed the tax which is paid to the 'government revenue pool'. To avoid the problem of failure to discharge refunds claims, which exists in most developing countries, the procedure of refunds needs to be clearly set out. The practice may vary from country to country. For example the IMF (FAD) has advised in some cases that imported foreign capital equipment be exempted for certain investors.²³⁹

Where a taxpayer has applied for a refund of any VAT paid in excess of the amount which is due under the provisions of the Act, and the Commissioner is satisfied that VAT has been overpaid, he has three options²⁴⁰: - apply the amount of tax overpaid against any outstanding liability of the person under the VAT Act; apply the balance of the tax overpaid against any outstanding liability of the person under the Income Tax Act, 1993; or refund the remainder to the person applying.

Where a person fails to pay VAT which is due to the revenue office, the Commissioner may make such arrangements to facilitate the collection of the tax from the person liable for that tax. This will be treated as a debt to the Government and the Commissioner is given the right to institute legal proceedings or to take any action to recover such payment from the vendor.²⁴¹

The Act provides for the mechanism of objections and appeals against any assessment made by the Commissioner to a vendor. The initial objection can be filed

²³⁹ Ebrill, L., et.al, *The Modern VAT*, op.cit. p.156, it is noted that the FAD advised Gabon to exempt foreign capital equipment for certain investors

²⁴⁰ Section 46 (2) Lesotho VAT Act

²⁴¹ Section 38 (3), Lesotho VAT Act

with the Commissioner, who is mandated to consider such an objection either in whole or part. The Commissioner has to communicate the objection decision to the person objecting and this has to be in writing. If the person objecting is not satisfied with the decision of the Commissioner, he can appeal to the Tribunal and thereafter to the High Court of Lesotho.

Furthermore, the Commissioner should make recommendations for the establishment of a VAT Tribunal as part of the appeals structure and process to deal with appeals either from the Commissioner or the vendor. This will ensure that both the traders and the Commissioner can bring their appeals to this body. The establishment of the Tribunal is important for the effective implementation of the VAT system and to review any decisions by the Commissioner on assessing taxpayers. It will also contribute to the interpretation of the legislation and relieve the burden of cases from the courts. However, there has not been a VAT tribunal in Lesotho even after three years of the implementation of the tax.

It is also beneficial for the system that the Commissioner keep up with the various developments of business activities and modern technology which are likely to raise challenging issues for VAT. For example, these include challenges which arise from the use of e-commerce in relation to VAT and modern issues of cross-border trade and VAT. These challenges are beyond the theme of the present study, but are developments which will affect the continued operation of VAT in Lesotho.

Administration of tax has been a concern in Lesotho for a long time and the system can benefit from measures which are aimed at strengthening the administration mechanisms by the government. It appears that effective administration mechanisms can be the basis for implementing VAT efficiently.

3.4 Conclusion

The main focus of this chapter is the analysis of the VAT legal framework in Lesotho. This is discussed in reference to established legal precedents from South Africa, the UK and the decisions of the ECJ on principles which are similar to the ones in the Lesotho

legislation. The emphasis of the analysis is on the main principles which underlie the VAT structure in Lesotho.

The examples are used to demonstrate how other VAT systems have dealt with the interpretation of the legal terms which are enshrined in the Lesotho VAT legislation. Though VAT has now been implemented for 4 years in Lesotho, there are no cases which have been referred to the courts. Since the VAT Tribunal has not yet been established, it can only be presumed that cases from other countries will be persuasive in cases of a similar nature. A tribunal is an essential part of the appeal's process in order to ensure the efficiency of the VAT system. Though an appeal can be made to the Courts, an appeal to the tribunal would provide a cheaper method as opposed to appealing to the courts. Furthermore, the problem in Lesotho with the appeal system to the courts is the time the courts take to deal with these cases. There is a back log of cases to the Courts and the establishment of the tribunal would solve this problem in that some cases would be dealt with by the tribunal without having to be taken to the courts. This would have the effect of cost-saving on both the business entities and the tax administration.

The legal structure of the VAT system underlies the principles which are enshrined in the system. The question therefore is whether the legal structure of the Lesotho VAT system is clear as to the nature of the tax and how it has to be implemented? It appears that the structure of the VAT system in Lesotho is simple and easy to understand. This means the system would therefore be easy to comply with while at the same time it is easy to administer. The VAT system in Lesotho displays some similarity to other VAT laws around the world in the provision of the basic features and principles of the VAT tax. In this respect, it can be argued that on the face of it, the VAT legal structure in Lesotho is inclusive and does reflect the nature of the system of VAT as it is implemented.

The practical implementation of the VAT in Lesotho appears in the chapters to follow and the discussion reflects the challenges of implementing the legal regime.

4.1 Introduction

The establishment of Lesotho Revenue Authority is a result of the government's initiative to strengthen the administration of tax in Lesotho. The objective of this initiative was to improve tax administration and to achieve an efficient stable tax system. LRA replaced the civil service type of tax administration which was part of the Ministry of Finance (MOF).

The aim of this chapter is to examine critically the administrative framework for the implementation of VAT in Lesotho. Firstly, the chapter examines the previous sales tax system and its administration. The discussion highlights the administrative problems which undermined sales tax. Secondly, another point of focus is the structure, advantages and disadvantages of the national revenue authorities which are charged with tax administration with particular focus on the establishment of LRA. We argue that the establishment of a national revenue authority is an effective way to achieve efficiency in tax administration where it has sufficient resources and full support of the government. It also looks at the role of LRA in the implementation and administration of VAT in Lesotho. We do not go into details in examining at a general level the role of LRA in administration of tax in Lesotho, but rather focus on its role in the implementation of VAT.

4.1.1 Methodology of the Research

The information which is used for analysis in this chapter was obtained during a 4 months internship with the LRA. The analysis does make some brief reference to academic writings in regard to principles which form the main theme of the chapter and the general theories in tax administration. An application was made to the Commissioner General of LRA to carry out an internship at the Authority for purposes of collecting

data on the administration of VAT. The request was granted and I was advised by the administration that it would be useful to take up the internship after (at least) a period of 6 months of the implementation of VAT. The conditions of the internship were; that LRA will get a copy of the thesis when it is completed; (this was to ensure that they will also benefit from the research); signing the terms of reference for the use of data acquired from LRA; signing the declaration form and undertaking an oath of secrecy in the use of taxpayers' information.

The internship took place from January to April 2004.²⁴² I was attached to the VAT Division within LRA under the supervision of the Assistant Commissioner responsible for collection and taxpayer services. The Principal Collector within the Division was directly assigned to ensure that I accessed information and assistance from within the Division and the other Divisions (Customs and Excise; and Income Tax). Furthermore, the Principal Collector assisted in arranging interviews with the different officers within the Division; the Commissioner of VAT, the Assistant Commissioners, and with the two Principal Collectors. An interview was also held with the senior officer from the Customs and Excise Division who is responsible for collection of VAT at the border posts. The information and material which was available included:-

- Information relating to sales tax and some reports relating to the collection of revenue under sales tax. However, most of the reports in this respect were missing;
- Some of the reports from the previous studies which were undertaken by the IMF (and the senior officers within the MOF) on sales tax and the recommendations on the introduction of a VAT;
- The general information about the taxpayers including the registration lists which were divided according to whether the traders were under compulsory registration or voluntary registration. The registration lists were also compiled

²⁴² Even after I returned to Edinburgh in May, 2004, I have maintained contact with the Principal Collector of the VAT Division and other officers for purposes of getting in touch with the developments of administering VAT and the relevant reports. However, though some reports were made available, some were not and it was also impossible to interpret some of them. Furthermore, recently it has been difficult to get any responses from emails from the contact at LRA and has been impossible to access any official reports and I have mainly relied on information on the LRA website.

according to where the trader carried on their business (according to the different districts);

- The monthly and quarterly reports of the VAT division and LRA were also available from time to time, detailing the activities of the division, revenue collections, registration issues and specific issues about taxpayers' where applicable.

4.2 The Collection of Tax Prior to the Establishment of LRA

Before the establishment of LRA, revenue administration and collection was the responsibility of the MOF through three departments. These were; customs and excise department, income tax department and sales tax department. These departments were under the direct control of the MOF and were part of the civil service structure accordingly. These departments were responsible for the administration and collection of different categories of tax. (1) Customs and Excise department was responsible for data collection on imports and exports. Import data is quite significant for purposes of determining Lesotho's share of revenue from the SACU revenue 'pool' shared amongst the member states; (2) The Sales Tax department was responsible for collection of sales tax at the border posts of Lesotho with South Africa and from unregistered persons; and (3) The Income Tax department was entrusted with the mandate of collecting personal income tax, company tax, fringe benefits tax, withholding tax and the gaming levy.

These departments operated independently of each other, though they were all under the management of the Commissioner of Revenue. Each department focused on tax collection and issues which related to the particular department only. In practice there was no exchange of information between these departments on taxpayers' matters or any other tax matters; they were not properly coordinated, and did not share tasks even where that was possible.²⁴³ For example, for collection of sales tax and customs duties from imports at the border posts, each department had their own officer to collect either sales tax or customs duties. The departments did not coordinate the collection of

²⁴³ Lesotho Economic Reviews, *Central Bank of Lesotho Publication*, August 2003 p.2

tax by one officer at a time. This meant that the business entities and the private consumers had to go through different process and complete different documentation for revenue collection at the border posts. This shows that there was lack of communication and cooperation between the departments. These departments could use one officer and devise a means to reduce the lengthy process of completing different documentation for the taxpayers. This resulted in inefficiency in revenue collection by the departments.

The other problem which undermined the tax administration at the time is that the staff members were public servants employed directly by the government. This means they were paid according to the civil service payment structure, which was based on low salary payments with limited benefits. This resulted in low morale amongst the members of staff. It also appeared that there were limited opportunities for career development and training opportunities as government employees. Therefore, these departments lost their trained and skilled officers to the private sector where there were better job and career opportunities. Without their trained and skilled tax officials, these tax departments experienced all kinds of problems such as mishandling the tax information by the unskilled tax officials, lack of efficiency in revenue collection and tax administration, and an absence of tax inspectors was also part of the problems which undermined the tax administration.²⁴⁴ The underlying problem related to alleged corruption of tax officials across the departments and mismanagement of the governments' revenue. This could be attributed to the fact that these officers were tempted to misappropriate the governments' revenue as a result of the low salaries, lack of benefits, and lack of professionalism on their part.

Furthermore, the tax system at the time was not computerised and as a result the taxpayers' information was not easily available. In some cases, tax records for administration purposes were not available. For example it was difficult to exchange information and documents between the border posts and the head office. This means that unless the invoices and the documents reflecting the tax collected and the level of imports into the country had been delivered physically, the office would not have

²⁴⁴ See King, J., Walsh, J.T., and Laycock, I., "Lesotho: Implementing the VAT and Strengthening Tax Administration", *op.cit.* p.3

records and information pertaining to the transactions. This caused delay in processing taxpayers' records and difficulty in cross referencing information.

The other problem which could be observed was lack of adequate resources for the officers at the border posts. These include adequately furnished offices, availability of stationery, photocopying machines and computers to enable them to do their job efficiently. Where there is lack of office equipment and the office space is also not adequate, it could demoralise the staff. These problems led to the inefficiency of the administration and had tremendous impact on the tax system, particularly the implementation of sales tax. The inefficiency of the administration resulted in a failure by the government to realise substantial collection of revenue, particularly from sales tax as shown above. This resulted in loss of revenue which was due to the government. These problems undermined the entire tax system and led the government to restructure its tax administration structure. These administration changes are discussed below.

4.3 Administration Changes: Choice of a National Revenue Authority

Tax administration has been a major problem in the majority of tax systems in developing countries and has had tremendous impact on collection of taxes in general. During the last decade the developing countries have implemented comprehensive tax reforms relating to their tax administrations, particularly in countries in Sub-Saharan Africa. The tax reforms focused on the shift from the administration of taxes by separate departments within the MOF to national revenue authorities (NRA).²⁴⁵ The traditional and common practice is that the various tax departments operate independently under the administration of the MOF. As highlighted earlier, this type of administration was characterised by a lot of problems in Lesotho and this had a tremendous impact on revenue collection. Countries which have shifted to this new model of tax administration and established national revenue authorities in Sub-Saharan Africa are listed in Table 3.

²⁴⁵ Mann A., "Are Semi-Autonomous Revenue Authorities the Answer to Tax Administration Problem In Developing Countries? A Practical Guide" *prepared for the United States Agency for International Development*, August 2004, p.1, www.fiscalreform.net/research/pdfs/sara_study_final_jan-4-2005.pdf, site visited in September, 2005

Table 3 - Sub-Saharan countries with a National Revenue Authority

Countries with NRA *	Date of Establishment
Botswana	2000/2001
Ethiopia	2002
Ghana	1986
Kenya	1995/1996
Lesotho	2002/2003
Malawi	1995/2000
Rwanda	1998/2000
Sierra Leone	2002
South Africa	1996/1997
Tanzania	1995/1996
Uganda	1991/1992
Zambia	1993/1994
Zimbabwe	2000

*Source – Mann, A., “Are Semi-Autonomous²⁴⁶ Revenue Authorities the Answer to Tax Administration Problem in Developing Countries? A Practical Guide” August, 2004. This table has been slightly modified for purposes of the discussion to emphasise the NRA’s in countries in Sub-Saharan Africa. Therefore, it does omit other developing countries which were included in the original table.

Although each of these countries established a NRA for different reasons and under different circumstances, it seems that there exist similar pattern with respect to underlying political and economic conditions in the countries. The widely held view seems to be that “the majority of governments have been dissatisfied with the level and efficiency of revenue collections, especially in the face of fiscal deficits and expanding public expenditure needs.”²⁴⁷ Furthermore, in most of these countries there were also

²⁴⁶ Ibid, in this article Mann calls them ‘semi-autonomous revenue authorities’, but in this thesis I have adopted the term ‘national revenue authorities’ as this is how most of them are known in Sub-Saharan Africa.

²⁴⁷ Ibid

concerns amongst the taxpayers and the private sector about the escalating corruption within the tax departments. This was the case for example in Tanzania.²⁴⁸

Moreover, it also appeared that there was a high level of tax evasion amongst those who legally required to register and were obliged to pay tax. Lesotho serves as a good example of this point. These problems undermined the general administration of taxes within a country and the efficiency of the tax systems. Though a NRA is regarded as an option to address some of the problems which undermine tax administration, there are other options which can be used to strengthen and restructure tax administration.²⁴⁹

4.4 Why a National Revenue Authority?

A NRA is a semi-autonomous body which is self-financing and under the management of board of directors. The administration is no longer the responsibility of the MOF but of the General Commissioner. However it is still the responsibility of the Minister of Finance to ensure that the fiscal policies of a country are effectively implemented and also to coordinate revenue collection. This means that the Minister of Finance still has a supervisory role over a NRA. These NRA's have been very popular in the last 5-10 years, particularly in developing countries. The question that arises is why are these NRA's regarded as a better option for tax administration? This question is examined by looking at the general arguments which are made in favour of establishing a NRA.

First, a NRA is favoured for its autonomy from political interference and administration. This means that the government does not interfere with the affairs of the authority, as the General Commissioner is given more powers to be in charge of the general administration of the authority. The increased autonomy of a NRA is intended amongst others to improve the accountability of revenue officers and the organisation as a whole; and to improve the efficiency of tax administration.

²⁴⁸ Fjeldstad, O., "Fighting fiscal corruption: The case of the Tanzania Revenue Authority" *Public Administration and Development* 2003 Vol.22 No.2 pp165-175 p.1

²⁴⁹ The other options of tax administration are: - Modified civil service departments and transfer of revenue responsibility to the private sector. These options were regarded as unsuitable for Lesotho

Second, a NRA has the responsibility to improve the revenue collection and administration strategies. As an autonomous body the NRA has powers to develop its terms of reference and to introduce measures which are intended to improve ways of collecting revenue. The NRA has to introduce measures which are aimed at achieving the efficiency of the tax system and ensure that it adopts measures to “improve the credibility of taxation with a view to earn more support from the government, private sector and the taxpayers.”²⁵⁰

Third, under a NRA the General Commissioner is given more rights and powers to employ better qualified and skilled staff through transparent procedures. The administration offers highly competitive salaries and benefits to attract the most competent and efficient staff. This enhances the morale of the staff as they are employed under improved terms of service. The effect of these changes is to reduce corruption amongst the tax officers and to enhance the taxpayers’ confidence in the administration staff.

Fourth, the establishment of a NRA is also aimed at achieving the integration of various tax departments under one management. This is to enable the departments to be able to exchange information and share resources as a way to improve its services to the taxpayers. The exchange of information is also beneficial to the taxpayers, as they can easily access their information at any revenue office. This will contribute to the efficiency of the administration and the tax system. This means that the tax administration has to integrate the taxpayer’s information to ensure that it is accessible to all the tax departments. This can also be useful in simplifying compliance procedures for the taxpayers.

These advantages of a NRA have attracted some countries to review their administration structures. However, this does not mean that in all cases where a country has an inefficient tax administration and tax system, a NRA is an answer. It takes a lot more to ensure that the establishment of a NRA achieves long term stability of the tax system and tax administration. There has to be strong political support of the

²⁵⁰ Mann, A., “Are Semi-Autonomous Revenue Authorities the Answer to Tax Administration Problem in Developing Countries? A Practical Guide”, op.cit. p.1

authority;²⁵¹ non-interference in the affairs and management of the authority by the government; provision of sufficient resources to establish the authority by investing reasonable amounts of money to set up the institution; provision of substantial resources to attract skilled and professional staff and support a transparent recruitment policy of officers; and to gain support from both the private sector and the public.

On the other hand, the establishment of these NRA's has been criticised. Those who argue against a NRA as a means to improve and strengthen tax administration have put forward the following arguments: - Firstly, it is argued that this kind of organisation tends to concentrate on revenue collection and meeting targets which are set by the government. As a result, this tends to "overstretch the capabilities and capacities of the administration while trying to meet the revenue target"²⁵² which is set on a monthly basis. This point can be related to the position in Lesotho. Every month LRA through its tax divisions such as the VAT division has to meet the monthly target which has been set by the government. It was observed that at the end of each tax period, the Commissioner of VAT circulates the target for each month to the senior officers which they have to meet in their revenue collection. It is argued that this in a way shifts the concern of the officers from achieving the overall efficiency of tax administration, to concentrate on the number of vendors that have filed their returns and the amount of tax which each vendor has to pay. The revenue officers concentrated more on the big registered vendors that pay more tax simply to ensure that they meet their revenue collection target for the month, notwithstanding that their input claims might be high too.²⁵³ The target relates to how much tax the division should aim to collect from all the sources on a monthly basis. This is decided on the basis of economic indicators and the government expenditure on a monthly basis.

²⁵¹ Ibid, p.10

²⁵² Ibid, p.2

²⁵³ The idea of concentrating on big registered vendors was to collect substantial tax which will contribute towards meeting the monthly revenue target for purposes of compiling the revenue collection report for a given period

Secondly, the establishment of a NRA can result in resentment and conflict between the employees of the MOF and the employees of the authority. This can result from the notion of high salary payments and benefits which are enjoyed by the staff of the authority which are different from the salaries paid in the civil service. This can affect working relations between the two offices. This point cannot be substantiated in the case of Lesotho at this time, but it is at least a possibility.

Thirdly, in most cases the NRA's are established as part of the IMF's recommendations to strengthen tax administration, particularly in developing countries. In that way, it is argued that the NRA's and the style of management which they introduce are more a 'donor driven' project and part of the structural adjustment programme of the IMF, rather than being established in the economic interests of the concerned country. This follows from the fact that the NRA's do not necessarily take into account the needs of each country and do not reflect those needs. Those who recommend the establishment of the NRA's do not assess the long term sustainability of such institutions. This is reflected in the appointment of the senior managers and advisors of the authority who are appointed from a foreign country. This has been the case both in Lesotho and Zambia, where in each case the General Commissioner of the authority was appointed from New Zealand. On the other hand, this can be viewed as an advantage, in the sense that it is better to appoint a person with experience in tax administration of a similar type who can share the relevant skills and expertise with the people within a country to ensure that the process is successful.

Fourthly, studies which have been conducted which relate to the Tanzania and Uganda Revenue Authorities show that after some time the NRA's are not any different from the tax administration under the MOF. These studies reveal that; "problems of corruption, decline of revenue collection, constraints towards staff salaries and their promotion, lack of qualified staff within key areas and a decline of autonomy as the Board interferes from time to time continue to exist".²⁵⁴

²⁵⁴ Mann, A., "Are Semi-Autonomous Revenue Authorities the Answer to Tax Administration Problem in Developing Countries? A Practical Guide", op.cit. p.vi

4.5 Establishment of Lesotho Revenue Authority

An Act establishing the LRA as the administration structure responsible for tax administration and tax collection in Lesotho was enacted in 2001²⁵⁵ and the authority was launched in 2003. This Act establishes the legal status of LRA. The LRA is established as a body corporate with a separate legal character and perpetual succession. It is capable of suing and being sued; it has the right to acquire and dispose of any property for purposes of carrying out its functions. This kind of legal status which is conferred on the Authority guarantees its autonomy and to an extent deters political interference. This gives the Authority the right to exercise its functions without interference from either the government or the board of directors.

The Authority is granted increased autonomy, though it is classified as a government agency and is under the general supervision of the MOF. The rationale behind increased autonomy to the authority is to limit direct political interference to the organisation by the MOF and the government in general with the aim of improving efficiency. This feature has proved to be essential in other countries whose tax administrations are effective. For example, the South African Revenue Service (SARS) has proved to be effective in tax administration because it is autonomous and free from any political and government intervention. Similarly, the Zambian Revenue Authority with the same feature has proved to have made significant changes with tax administration since it was established. It has also been shown that in the two countries concerned (South Africa and Zambia) the establishment of a revenue authority led to an increased revenue collection.²⁵⁶

The functions of the Authority are:-²⁵⁷ to make assessments of tax which is due to the government, collect and to receive revenue; to administer and enforce the revenue laws in Lesotho which are the Customs and Excise Act, the Income Tax Act, (the Sales Tax Act – before VAT was introduced) and the VAT Acts; to promote taxpayers'

²⁵⁵ Lesotho Revenue Authority Act No.14 2001

²⁵⁶ King, J., Walsh, J.T., and Laycock, I., "Lesotho: Implementing the VAT and Strengthening Tax Administration" op.cit. p.45

²⁵⁷ Section 5 (2), Lesotho Revenue Authority Act, 2001

voluntary compliance; to improve standards of service to taxpayers by undertaking measures to improve efficiency and effectiveness of revenue collection; to take measures to prevent tax fraud and tax evasion; and to advise the Minister of Finance on revenue policy issues, matters relating to the administration and collection of revenue.²⁵⁸ These functions clearly represent what the government would like this organisation to achieve by granting it more powers than the previous tax departments in order to be able to exercise its functions effectively.

The Authority has specific powers so that it can achieve efficiency in fulfilling its functions. These are: -²⁵⁹ To study revenue laws and propose any suitable changes for purposes of improving the administration and compliance with revenue laws; to calculate any administrative costs, compliance costs and operational impact of intended legislative changes to any revenue laws; and to collect and process statistics needed to provide forecasts of revenue receipts and the effect on yield of any proposals for changes in revenue laws.

LRA is given broader powers towards tax administration and revenue collection. However, most importantly the authority has to create an atmosphere which will ensure that both the private sector and the public are able to fulfil their tax obligations, by improving standards of service and establishing a relationship between all the parties concerned. The authority also has to investigate both administrative and compliance costs of any legislative changes to any revenue laws which the government may wish to undertake. Generally, the authority is entrusted with the mandate to advise the government on policy and technical issues which relate to the administration and collection of tax.

One important development which is introduced by the Act is that the revenue staff is given the power to exchange information or documents concerning any taxpayer, as long as that exchange is for purposes of discharging their functions under the Act. This enables the departments to be able to identify and follow taxpayers who are defaulting or avoiding the payment of tax much quicker and more easily than before. It is also to the

²⁵⁸ Section 5 (2) (a) – (f), Lesotho Revenue Authority Act

²⁵⁹ Section 6, Lesotho Revenue Authority Act

advantage of the taxpayers that they can access their tax information at one consultation point without having to go from one office to another.

Furthermore, the Act mandates the Authority to be subjected to periodic in-depth audits and taxpayer declarations. The objective behind this provision is to achieve transparency in how the authority discharges its duties and how it makes use of its resources.

4.6 The Management and Governance Structure

The management of the Authority lies with the Board of Directors which is established as the governing body of the Authority in terms of *section 8* of the Act.²⁶⁰ The Board is composed of eight members who are appointed by the Minister of Finance and drawn from different public and private offices. In appointing members of the Board, the Minister uses his discretion to appoint a person of high integrity and someone who has no record relating to tax evasion. The Minister in this respect has to rely on the advice of the officials from the administration.

The functions of the Board are:- to give instructions to the Commissioner-General (Commissioner) in connection with the management, performance, operational policies and implementation of the revenue departments; to formulate and devise a system for ensuring the correct processing of all tax cases through internal audit systems; to prescribe such administrative measures as may be required to safeguard the revenue and to exercise disciplinary control over all the members of staff of the Authority.²⁶¹

However, the most important provision is *section 15 (2)* which provide that the Board shall not intervene in the determination of any revenue assessment, revenue liability of any taxpayer or in any tax appeal. Though the Board has the powers to protect revenue and has an interest in revenue collection, it is barred from intervening in the processes of assessing taxpayers, as that falls within the responsibilities of the

²⁶⁰ Lesotho Revenue Authority Act

²⁶¹ Section 15(1), Lesotho Revenue Authority Act

Commissioner's duties. This is an administrative role where the Board should not intervene at all, since their role is more on policy related issues. It is important to draw the line between the duties of the Board and the duties of the Commissioner in order to avoid any tensions and clash between the two. The Board does not deal with the day to day administrative functions of the Authority but it deals with the policy and the organizational structures of the Authority. It is also responsible for general supervision of the Commissioner in the management of the Authority.

The Board has the powers to appoint the Commissioner-General²⁶² who acts as the Chief Executive of the Authority. The Commissioner is appointed on the terms and conditions which are set out by the Board and the terms have to be approved by the Minister. The Commissioner is placed under the general supervision and control of the Board in discharging his managerial and administration duties. The Commissioner is responsible for: - the day to day operations of the Authority; the management of the funds, property and business of the Authority; the administration, organization and control of the officers and staff of the Authority; and the effective administration and implementation of the LRA Act.²⁶³

4.7 Preparatory Measures Towards the Introduction of VAT

One of the initial tasks of LRA was to undertake plans for the introduction of VAT and adopt appropriate measures to achieve that objective. The first task which LRA had to concentrate on was to finalise the drafting and reviewing of the legal regime of VAT. The legal basis of VAT derived from the VAT Act which was enacted before the establishment of LRA. Therefore, the authority had the duty to ensure that recent tax developments are incorporated in the Act. This involved revisiting the VAT Act (2001) and implementing any amendments which had to be made. The second task was to identify the other aspects of the legal regime which could not be included in detail in the

²⁶² Section 2 of the Lesotho Revenue Authority Act provides that "Commissioner-General" means the Commissioner-General of the Authority appointed under section (17)

²⁶³ See chapter 3 (paragraph 3.3.12) on the duties of the Commissioner-General

Act. These aspects are identified from the Act and have to be developed as part of the VAT Regulations. The Regulations have to comply with the VAT Act and to expand on issues dealing with the registration threshold and the list for zero rating.

The other task which the LRA had to focus on as part of the preparatory measures for VAT was to publicise the introduction of VAT, how it works, its advantages and disadvantages to the administration, the public and the private sector. The administration had to justify why sales tax was being replaced by a VAT and therefore it was important that this is well publicised in order to gain the support of all parties. This would form part of the preparatory measures in any country where a new tax is being introduced. In the case of Lesotho, publicity and education campaigns were very crucial in the case of VAT, in view of the fact that the implementation of sales tax had been undermined by a number of problems. Therefore, the administration intended the implementation of VAT to be more efficient. The publicity campaign and education was important to ensure that the government gets the support of the private sector, the business community and the consumers on the effective introduction of VAT.

Another task which the administration had to focus on was the recruitment of staff. Since the establishment of LRA was intended to address the failures of the previous tax administration system, it seems logical to argue that they wanted to recruit highly qualified and skilled people to join the organisation. It would also be important for the administration to develop a code of conduct for people who would be recruited and employed to ensure that they introduce professional conduct and ethics within the Authority.

In terms of *section 21*²⁶⁴, when the Act came into force, a public officer who was employed in the revenue departments (prior to LRA) could apply to the Authority for employment and if successful he became the employee of the Authority and was regarded as having retired from the Public Service. Where a public officer was not interested in joining the Authority or an officer was not successful in securing employment with the Authority, the officer was re-deployed within the Public Service in

²⁶⁴ Lesotho Revenue Authority Act

another office if a suitable office was available. This is an indication that the Authority was trying to establish a separate calibre of officers, who should be seen as different from the civil service officers. This is seen from introducing different recruitment procedures, by offering different employment terms from the public service, and by introducing different payment and other remuneration packages.

The other issue which constituted an important point of focus for the administration was to decide which department would oversee the implementation of VAT.²⁶⁵ VAT was replacing sales tax which had been a separate division from the other tax divisions. On the basis of that fact, the administration decided that VAT should be a separate division when sales tax was phased out. In this respect, VAT would be able to take over and inherit things like outstanding debts of sales tax.²⁶⁶ Though VAT remains as a separate division which is responsible for the administration and collection of VAT, the Customs division collects and administers VAT on imports at the border posts and other points of entries. The reason behind this is that all the divisions are now part of LRA which is responsible for the administration and collection of all taxes. This task is divided accordingly within the three divisions which are: - Income tax division; Customs and Excise division; and VAT division. Therefore, the collection of VAT on imports remains with Customs division as part of their responsibility to regulate cross-border movement of goods. The customs officers collect the tax on goods imported by non-registered traders and consumers and in some cases by registered traders.

Generally, it seems there are two main factors which justify the allocation of VAT administration on imports to Customs. Firstly, the significance of VAT which is collected on imports and its contribution towards total VAT revenue justifies the administration of VAT to Customs. It appears that in developing countries between 40 per cent and 60 per cent of the total VAT revenue is likely to be collected by customs on

²⁶⁵ King, J., Walsh, J.T. and Laycock, I., "Lesotho: Implementing the VAT and Strengthening Tax Administration" op.cit p.26

²⁶⁶ This point can be substantiated by the fact that when I visited the LRA offices for the first time (January, 2004), I noticed that the signs which indicated which departments were part of LRA, sales tax appeared on the signs at that time. VAT had been introduced on 1st July, 2003. It appeared that the offices which were used for sales tax had just been transformed so as to be used for VAT

the import of goods.²⁶⁷ In the case of Lesotho at the time the administration could have expected VAT which is collected on imports to be significant since Lesotho is mainly an importing country. Secondly, the other important consideration is the experience of Customs officials with physical control of goods. Further Customs is knowledgeable about collecting indirect taxes and more familiar with issues such as the classification and valuation of goods.²⁶⁸ This is therefore one of the reasons why in Lesotho the administration decided that the collection of VAT on imports should be the responsibility of Customs officers.

Customs is responsible for regulating the movement of goods into and out of the country; therefore customs officers are conversant with the classification and valuation of goods. This means that they do have the knowledge and experience of customs duties which are imposed at the border entries. Some of these issues of regulating movement of goods in and out of a country also relate to the implementation of a VAT. This gives them an advantage in dealing with VAT at the border entries. Moreover, the Customs officials are familiar with dealing with taxpayers at their offices and they are likely to have established good contact and good working relations with taxpayers. However, where Customs officials are not helpful to taxpayers and have not established good working relations with the taxpayers, this can be a disadvantage of Customs officials dealing with VAT collection.

Furthermore, Customs has a duty to monitor the movement of goods which are produced locally and ensure that they are exported and not diverted into the domestic market. In Lesotho exports are zero-rated, this means they leave the country tax free. Therefore, the role of the Customs officials and the VAT officers is to ensure that exporters have recovered their input costs before the goods are exported.

This discussion shows that it is important for the administration to decide which department takes charge of VAT and general transitional issues require to be well planned. The preparatory measures towards the implementation of a VAT in Lesotho were introduced in two stages. The first stage was the establishment of an

²⁶⁷ See Tait, A.A., *Administrative and Policy Issues*, op.cit. p.50

²⁶⁸ See Ebrill, L., et.al., *The Modern VAT*, op.cit p.129

Implementation team during the transition period, when sales tax was being phased out and a permanent structure for the implementation of VAT had not been created. The second stage was the establishment of the VAT division and the administration structure of the division. These two developments are discussed below.

4.7.1 The Implementation Team²⁶⁹

The objective of establishing an Implementation Team was to maintain a transitional structure which would be responsible for initiating the implementation process of VAT before setting up the VAT division. The Implementation team had the responsibility to undertake preparatory measures for the introduction of a VAT in the absence of a permanent structure directly responsible for dealing with such measures. The team also had the task of introducing a training programme for the administration staff to ensure that they have the necessary knowledge about VAT issues, particularly those which are relevant to the implementation of VAT in Lesotho.

The team was composed of Heads of sub-teams and officials which were appointed from LRA.²⁷⁰ The team was made up of officers from the various divisions which include the Legal division, Information Technology division, Audit and Registration Unit, Human Resource division and the Customs and Excise division. The first task of the Implementation team was to draw up an action plan which set out clearly how the preparatory process would proceed.

The team was divided into four sub-teams.²⁷¹ The size of each sub-team differed in terms of the tasks involved, though in each team there were between 5-8 officers. The sub-teams were divided according to the type of activity which had to be carried out. First, there was the Legal sub-team which was responsible for all legal activities which had to be carried out. The team composed of revenue officers from the LRA Legal Unit,

²⁶⁹ See VAT Implementation Master Plan, May 2003, LRA Reports – May 2003 and confirmed in an interview with the Assistant Commissioner, Taxpayer and Collection Unit, January, 2004 -LRA

²⁷⁰ Information obtained from an interview with the Assistant Commissioner, Taxpayer and Collection Unit

²⁷¹ Information obtained from an Interview with the Assistant Commissioner, Taxpayer and Collection Unit, and see also *VAT Implementation Master Plan*, op.cit. p.3

since they had the expertise in the field. However, in carrying out some other tasks, such as revising and proof reading the VAT forms and manuals to ensure that they were correctly printed, the other members of the Implementation team had to assist this sub-team.

Second, there was the Import VAT credit facility sub-team²⁷² which had the duty to develop and implement the import VAT credit facility system²⁷³ upon the introduction of VAT. It also had to develop a computer database system which would be used for purposes of business entities that would be part of the scheme. The sub-team had to assess the training needs of the customs officers who would be involved with the implementation of the system. The members of the sub-team were the officers from the Information Technology unit of LRA, since the major tasks involved specialised duties of developing a data base to be used to store the taxpayers' data which relates to Import VAT.

Third, the VAT Registration sub-team was also established. It had the task of determining the registration threshold to enable the Legal sub-team to draft a legal notice to that effect. Furthermore, this sub-team had to develop and print the registration forms for use by vendors; and to develop a VAT input refund mechanism which would be adopted and effective. The sub-team was also expected to consolidate taxpayers' information and facilitate the exchange of existing information on taxpayers with the Income Tax and Customs and Excise divisions. The sub-team was composed of all the team members of the Implementation team. Since this was more of an administrative issue and the tasks involved were general in nature, each member of the team had to take part so that they could also familiarise themselves with the issues which relates to

²⁷² See the *VAT Implementation Master Plan*, op.cit. p.1

²⁷³ The Lesotho Revenue Authority introduced a mechanism into the operation of VAT called an Import VAT Credit Facility (Deferment System). This system defers payment of VAT by the importer each and every time they import goods into Lesotho. The system captures all imports into the VAT payment network and the statement is printed at the end of the month. The importer settles the import VAT bill on or before the next tax period (when the importer files the monthly return). Importers can be approved for the scheme under the following conditions: (1) all tax returns for all taxes due, being Sales tax, VAT and Income Tax have been submitted; (2) the importers annual value of imported goods exceeds M1,000 000.00 (One Million Maloti); (3) a schedule of the importers monthly importations is attached to his ordinary VAT return for the same month

taxpayer registration.

Fourth, there was the VAT Publicity sub-team²⁷⁴ which had the responsibility to deal with all activities relating to the publicity of the tax. This team was made up of officers from the Advertising and Marketing Consultant and the Information Technology Unit. The task of this sub-team was to engage in publicity and marketing on the introduction of VAT in Lesotho, both to the private sector and the public. This activity involved issuing and distributing brochures, radio sessions of broadcasting on how VAT worked and explaining its advantages, organising conferences and public meetings and designing posters and distributing them.

The other crucial issue which needed to be dealt with during the transitional period is the process of consultation with the traders, different business representatives and the public at large. This is to give these groups the opportunity to contribute to the final version of the legislation and to get their views across in relation to issues of threshold, registration requirements and trader identification issues, zero-rating and exemption of certain goods and services. This ensured that small traders were represented and that they were recognised in relation to VAT.

It was also important for the administration to develop efficient taxpayer and trader education as well as public awareness programmes. Communicating the requirements of the legislation and any information relating to VAT to those who are directly involved in the compliance in relation to the tax is crucial for effective implementation of the tax. This means that distribution of information to all parties, the traders and the public is a fundamental part of the implementation process. It is therefore submitted that this places an obligation on the government and administration to disseminate information widely through newspapers, radio stations, leaflets and pamphlets to be handed over directly to the traders.

The Implementation team in Lesotho had the responsibility to disseminate information across the country to all traders and to the public. Information leaflets were printed out and distributed in various parts of the country and also made available at the

²⁷⁴ *VAT Implementation Master Plan*, op.cit. p.2

border posts. Radio programmes were initiated and broadcast and local newspapers were also used to disseminate information about the tax. The extent to which this task was achieved cannot be completely verified. However, it was observed that pamphlets were printed and were accessible from the VAT offices reception area for the public to pick up. In the same way, at the border posts there were leaflets and pamphlets which were available for the public.

The education and awareness process can also be achieved by carrying out informational visits to the places of business by the VAT officers. It might not be possible to visit all the taxpayers prior to the implementation of the tax, but this process can be continued by the tax inspectors even after that, with the objective of giving the vendors all necessary information about the tax.

In achieving dissemination of information, it is important that the language in which the information packs and leaflets are written is simple and clear to the business entities and the public. The drafters should avoid the use of complex legal terminology which is in the VAT legislation, but should set out the obligations of the business entities and the other legal requirements in a simple manner. It seems it would also be useful to some of the business entities and the public to produce some of the information material in the local language, which is common and known by all the people. For example, this is relevant in the case of Lesotho as it would target some of the smaller business entities that are largely illiterate but at the same time need to know about VAT. Similarly, this can be useful even for the larger business entities that are not conversant with either English or the local language (Sesotho), such as the Chinese and Indian business entities. These business entities are assisted by local people, some of the employees also do not understand English very well. In this way the assistants have to read the information packs and leaflets in Sesotho and translate the material to the traders (employers). The problem with respect to translating the requirements of the tax into the local language is that sometimes, the local language may lack appropriate terms for effective translation of some of the legal terms used in the VAT legislation.

Lesotho, as a small economy, has seen most of its manufacturing and exporting business enterprise being controlled by foreign traders. These are mainly owned by

Chinese business entities and a few by business entities from South Africa. Some of the business enterprises which are commonly owned by foreign business entities are clothing and retailing shops; and manufacturing industries and distributors. The fact that Lesotho's economy tends to rely on foreign companies and investors raises questions of its stability and long-term prospects. This can be a disadvantage since foreign companies and investors can always pull out and invest in another country.

Another important area of focus for the Implementation team was to develop a training plan for the staff.²⁷⁵ Training of the administration staff and the tax officers forms an important aspect of the preparatory measures towards implementing a VAT. In the case of Lesotho in particular, it can be argued that the training programme of staff had to be very intensive since the management had recruited new staff. Although they were qualified in some respects some of them had no experience of revenue administration and collection. Even those who were recruited from the administration staff which was responsible for implementing sales tax had not gained enough experience to deal with a VAT, due to the various problems which had undermined the sales tax system.

The objective of the plan was to ensure that training would be more focused on VAT administration issues and professional ethics. This was to ensure that the officers would understand their role and their obligations within the VAT system to effectively deal with taxpayers, demonstrating high standards of professionalism. This would improve the relationship between taxpayers and revenue officers and result in a positive attitude towards taxation and tax administration.

However, the important question which can be raised is whether in practice the officers were able to demonstrate and employ the knowledge and skills to deal effectively with issues arising out of implementing a VAT. This point is investigated in

²⁷⁵ VAT Training Implementation Action Plan, updated in April 2003, LRA documents

chapter 5 by examining VAT administration in practice and how it is viewed by the business entities.

In examining these activities which various sub-teams had to deal with, it can be argued that though all the activities were extremely important and had to be achieved before the VAT could be implemented, the following activities can be identified to be a priority to the VAT system: - developing the registration of taxpayers' database; developing the TIN issuing registration certificates to taxpayers; and publicity campaigns. The reason why these activities are regarded to be more important is that they are basic to any VAT system and the system cannot be implemented without such activities being completed. It is true that even when VAT is already in place these activities have to continue as long as there are new business entities that register at the time. These preparatory activities had to be completed before VAT was introduced and came into force. Though some of the activities were expected to continue beyond that date, the administration had to ensure that the initial stages of activities relating to the publicity of VAT and registration of vendors had been completed.

LRA had 6 months to complete preparations for the implementation of VAT, from January (when it was launched) to June 2003. VAT was introduced on the 1st of July that year as planned. The preparation time differs from country to country and depends on the nature of the preparatory measures which have to be undertaken within each country. It can be argued that the implementation of VAT in Lesotho has partly been successful and partly problematic.²⁷⁶

²⁷⁶ See challenges of the VAT system at paragraph 4.9 and chapters 5 and 7 where the successes and problems of the VAT system in Lesotho are highlighted

return processing and collection; and accounting in the districts. These revenue officers in the districts are also responsible for the collection of VAT.

One of the first tasks of the VAT division was to develop an appropriate data base to capture and compile the taxpayers' information. This data base is referred to as the Value Added Tax Information Processing System (VIPS)²⁸¹ and it is useful for compiling all the taxpayers' information for administration of VAT and other taxes. The use of a computer database by the administration is a significant development in the administration of VAT (and tax in general) in Lesotho, which has enabled the administration to be able to compile the information and records of vendors and ensure its accessibility. This was not the case under sales tax, as there was lack of reports and taxpayers' information, which made it difficult to access the information. This problem had also led to poor record keeping of revenue collection during that time. Therefore it resulted in a lack of useful records for the purpose of comparing revenue collection under sales tax and VAT.

4.8 Implementation of VAT – July 2003 Onward

VAT was introduced on the 1st July, 2003 and that marked the beginning of a new tax system in Lesotho. It seems that the administration's task of registering business entities continued into the first three months of implementing VAT. Registration of business entities for VAT purposes is an ongoing process, however it can be assumed that in cases where the tax is being introduced for the first time; the process is likely to take longer since both the business entities and the administration are adapting to understand the system.

Another area of focus in the first months after VAT was introduced was to deal with cancellation of registration for those vendors who should not have registered.²⁸² This is discussed further below with reference to statistics on deregistration in the first year of implementation of VAT.

²⁸¹ An Interview with the Assistant Commissioner, Taxpayer and Collections Unit

²⁸² Ibid

The following discussion on the administration of VAT concentrates on two themes, registration (including cancellation of registration) and revenue collection. The reason why the two themes are chosen is that it seems that the issues which were central to the administration of VAT in Lesotho when it was introduced were mainly related to registration and revenue collection.

4.8.1 Registration

This part focuses on the practical issues of registration since the introduction of VAT in Lesotho. Registration involves a trader completing a VAT registration form including all the details about the nature of the business; its location and address. When the registration is complete, the VAT officers allocate a registered trader with an identification number which is usually referred to as a 'taxpayer identification number' (TIN). This number is used in all tax matters which relates to the trader. This means that the registration number identifies the trader in relation to all his tax obligations. In April 2005 the administration in Lesotho introduced a new TIN for all registered taxpayers. This new identification numbers can be used by taxpayers and business entities for all their tax transactions. This includes payment of all the taxes - income tax, customs and excise duties and VAT. This is an important development in consolidation of the taxpayer's information, which is relevant to all tax transactions. Therefore, this can be viewed as a factor to improve the administration of all types of tax.

During the first three months (July, August and September, 2003) of implementation of VAT 1,225 traders were registered. It can be argued that the number of registered traders gives an indication of the size of Lesotho's economy and the type of economy which exists. Like any other developing country, Lesotho's business sector is characterised by a large number of small business entities and an informal sector which is excluded from VAT. Therefore this leaves a small proportion of business entities which qualify to register. This is advantageous from the administrative perspective, since for purposes of efficiency it gives the administration the opportunity to deal with a small number of VAT returns and refunds. This gives them the opportunity to direct all

the resources to a smaller group of business entities that are registered and this can lead to administrative efficiency.

On the other hand, it can also be argued that administrative efficiency is not automatic where there are a small number of registered business entities. The case in Lesotho at the time of the sales tax system can be used as an example. The fact that there were a small number of business entities that were required to collect sales tax did not improve the administration situation at the time. There are other factors which have to exist for efficiency to result. However, it can be acknowledged that a small number of registered entities can reduce the administrative burden.

A summary of the number of vendors who registered between July 2003 and June 2004 (the first year of implementing VAT) was compiled from the VAT Division quarterly reports in order to highlight the numbers which the administration had to deal with. The statistics is summarised in four different periods of three months from July 2003 up to June 2004. This appears in Table 4.

Table 4 - Summary of registered vendors in Lesotho - July 2003 to June2004

July 2003 – June 2004	Total
July	
August	
September	1,225
October	
November	
December	1,304
January	
February	
March	1,358
April	
May	
June	1,331

*source – compiled from the *LRA Quarterly Reports*, July 2003 to June 2004

It is noted that the number of registered business entities varies in both directions. This depends on whether there has been any increase in firms which have set

up business ventures which engage in taxable supplies; and with turnovers which are above the minimum threshold. It appears from the table that the number of registered vendors has generally been going up, though in the last period the number did slightly go down.

The other significant point which can be highlighted about the system is that it seems that during the first tax period there were high claims to input tax credit by some large firms.²⁸³ It was revealed from the interview that most of these refunds claims were not paid after thorough investigation by the tax officials as it appeared that some vendors had made claims which were not supported by correct invoices.²⁸⁴ This could be attributed to lack of experience of how to calculate input tax or how the VAT system works. This could be addressed by continuous taxpayer education and visits to the businesses' premises when possible.

The administrative efficiency of VAT can be judged by the way in which the staff handles registration of vendors and tax returns. The first tax period brought a new experience for the vendors to assess themselves for VAT (which did not exist under sales tax). Therefore it could be anticipated that vendors would have difficulties with the filing process. However, it appeared from the monthly report and also confirmed by an interview with the Assistant Commissioner the filing of returns during the first tax period (which was on the 20th August, 2003) was high, since about 70 per cent²⁸⁵ of the registered vendors complied.

4.8.2 Cancellation of Registration

Cancellation of registration has also been an area of focus for the administration. The significance of cancellation of registration is to regulate the registration of business entities that are not obliged to register or those which do not make taxable supplies under the Act or those which have ceased to make taxable supplies.

²⁸³ Interview with the Principal VAT Collector, February 2004

²⁸⁴ Ibid

²⁸⁵ Ibid

During the first three months of the implementation of VAT, 31 vendors applied for cancellation of their registration.²⁸⁶ Out of this number, 2 vendors were deregistered by the administration while 29 applications were pending deregistration at the end of the period. The report does not elaborate on the reasons why these vendors applied for registration or why some were deregistered by the administration. In that case, personal views are given in this respect. It can be argued that the applications for cancellation of registration by vendors were from those who had registered without fully understanding the obligations which flow from registration. In respect of those vendors who were deregistered by the administration, it appeared that they were small vendors who might have stopped making taxable supplies or who did not have any place of business.

During the second period between October and December 2003, 65 vendors²⁸⁷ cancelled their registration while 20 applications had not yet been approved. There were various reasons why these vendors had applied for cancellation of their registration.²⁸⁸ It seems the administration also noticed that some vendors had duplicated their initial registration and initiated the process of cancellation of their registration; while others ceased operating after they had registered; and others had voluntarily applied for registration but subsequently decided to opt out of the system.

It appeared that when VAT was first introduced in Lesotho a number of small business entities were registered which need not have been. These business entities could have looked only at the advantages of registration and ignored the administrative burden placed on the registered vendors. Furthermore most of these business entities did not understand the possible risks which come with registration. For example they may have to account for output tax on a debt which proves to be bad; late returns and late payments might also lead to costs in the form of default surcharge and interest on VAT paid late.²⁸⁹ This is confirmed by the number of business entities which lodged their

²⁸⁶ Ibid

²⁸⁷ *VAT Division Quarterly Report*, October-December, 2003

²⁸⁸ Reference to this was made by the Principal VAT Collector in an interview in January, 2004

²⁸⁹ Wareham, R., and Dolton, A., ed. *Tolley's VAT Planning*, 1999-2000 (Tolley Publishing: Great Britain) p.772

applications for deregistration in the following months. Table 5 sets out the statistics of vendors who cancelled their registration, as well as those who had lodged their applications to cancel their registration with the Commissioner. The available statistics covers the period from July 2003 to June 2004 and this is summarised in periods of three months

Table 5 - Cancellation of registration statistics – July 2003 to June 2004

Period	Cancelled Registration	Pending Cancellation
July-September	2	29
October-December	65	20
January-March	31	50
April-June	14	7
Total	112	106

*source - information compiled from LRA reports – VAT Division - July 2003 to June 2004

A number of reasons²⁹⁰ have been given for this pattern of cancellation of registration by the vendors. It appeared that most of these traders were small traders who had registered for VAT voluntarily. The administration took the initiative to encourage these traders to cancel their registration as they held the view that these traders would not bear the burden of compliance with the VAT obligations. The other fear was that this would increase their compliance costs. It was also believed that these traders would not bring any significant revenue to the government ‘pool’; rather they would increase the administration costs.

As it appears from Table 5 the total number of business entities which were deregistered at the end of June 2004 was 112, whereas 106 business entities in total were awaiting the outcome of their applications for deregistration with the administration. The period between October and December saw the highest number of cancellations of registration at 65. The reason for this could be that some of the applications which were

²⁹⁰ Reference to this was made by the Principal VAT Collector in an interview

made during the first 3 months were only approved during this quarterly period. For example, vendors whose applications were previously pending were only approved during this period.

4.8.3 Revenue Collection

One of the government's concerns prior to introducing VAT was the decline of revenue which was collected under the sales tax.²⁹¹ The introduction of VAT was therefore seen as a means to raise more revenue for the government.

The design of a VAT does have an impact on its effectiveness and its performance within the existing social, economic and political factors in each country. The important structural attributes towards revenue efficiency of a VAT are: - First, the tax rates, which are usually influenced by the revenue needs and requirements of a country. Each country sets the tax rates according to the circumstances which exist in the country. Though the revenue requirements would be the major factor, the need to correct the tax system in order to achieve efficiency and neutrality would also be taken into consideration. Furthermore, the tax rates of neighbouring countries can also be a factor to consider, as was the case in Lesotho.

The second factor is the tax base, which deals with the broad coverage of both goods and services. A VAT system which covers both goods and services would bring more revenue than one which is restricted to either one of them.

Third, the extent to which the tax system excludes some sectors or some items from tax does have an impact on the revenue efficiency of VAT. Therefore, exclusions in the form of exemptions and zero-rating of various domestic items from tax should be restricted.

Fourth, another point to consider is the extent to which the rules guard against tax avoidance. It is argued that effective measures to control tax avoidance raise the potential for the revenue raising efficiency of a VAT. This means that where there is

²⁹¹ As it appears in chapter 1 there was an imminent decline of revenue anticipated in Lesotho from other non-tax sources as well, such as the SACU 'pool'

less avoidance there is a greater chance to collect more revenue. On the same point, the IMF provides that, “the revenue produced by a VAT depends on three broad sets of factors: the rules describing rates, bases, threshold, and other structural features of the tax; the scale of taxable activities; and the degree to which the rules are complied with.”²⁹² It is therefore concluded that a well designed and well implemented VAT has the potential to generate a high percentage of revenue within the existing economic growth of the country.

The VAT Division is directly responsible to administer and collect VAT in Lesotho. There are various units within the Division which collect VAT from different sources and transactions.²⁹³ These are:- the Return Processing Unit (RPU); the Car Clearance Unit (CCU); the Debt Collection Unit (DCU); the VAT offices from the districts; the Border posts; Import VAT credit Facility;²⁹⁴ and VAT refunds from SARS.²⁹⁵

The RPU processes the tax returns at the end of each tax period and collects VAT which is due from the vendors. It is responsible for VAT which is paid directly at the LRA offices. The CCU deals with collection of VAT which is payable on new and used cars whether they are purchased in the country or are imported. In the initial stages after the implementation of VAT, the DCU focused mainly on recovery of tax which was due from registered vendors under the sales tax regime who had failed to pay sales tax. Any tax recovered which was outstanding is then paid to the VAT Division and forms part of the VAT revenue. It can be presumed that this unit will also collect outstanding VAT from vendors who fail to pay tax at the time when the tax is due.

VAT is also charged and collected on imports originating from SACU countries or other countries at the border posts. This refers to Import VAT²⁹⁶ which is collected on

²⁹² See Ebrill, I., et.al., *The Modern VAT*, op.cit. p.43

²⁹³ VAT Division Report, July 2005

²⁹⁴ See footnote 273

²⁹⁵ This relates to VAT refunds payments from the South African Revenue Authorities which are paid over to LRA in terms of an agreement between concluded between the two authorities. See chapter 6 (which deals with how Lesotho charges VAT on cross-border transactions) for a detailed discussion of this agreement

²⁹⁶ VAT Division Report, July 2005

goods imported from SACU countries and VAT collected from countries outside SACU is classified as ‘VAT from the border posts’.²⁹⁷ VAT which is collected from imports from South Africa is classified as ‘VAT refunds from SARS’.

In the paragraphs which follow, I have compiled the statistics on revenue collection for the first year of the implementation of VAT in Lesotho. Reference to these statistics is to illustrate the amount of VAT which is collected from the different units and to show the pattern of revenue collection in the first year of implementing VAT. The statistics are interpreted with reference to the information which was available with respect to the contribution of each Unit. This is presented in quarterly periods, as this is how the statistics was compiled in the reports of the VAT Division. The use of the statistics is to show the contribution of each Unit towards the revenue collection of the Division during the period under review and also to highlight the revenue which is collected from VAT. It is acknowledged that the use of the statistics could have raised more challenging issues if it was presented in comparison with the revenue statistics from sales tax. However, the statistics dealing with sales tax was not available and even the reports which were made available were not in sequence of months or even years. Therefore, this presented a problem of analysis and presentation.

4.8.3.1 Revenue Collection for the Period Between July and September 2003

Table 6 - VAT Collection between July – September 2003

**The figures are shown in Lesotho’s monetary currency Loti*

Collection stations	July	August	September
RPU ²⁹⁸	20,961,143	26,299,948	23,944,815
Car Clearance	2,383,691	2,266,030	2,068,580
Debt Collection	719,587	672,701	882,803

²⁹⁷ Ibid

²⁹⁸ Return Processing Unit

Districts	1,609,419	1,836,941	1,912,178
Import VAT Border Posts	4,502,501	8,278,008	12,120,937
VAT refunds from SARS	—	4,042,831	7,956,000
Import VAT credit Facility	—	7,759,817	7,208,506

*source - VAT Division Quarterly report, July –September, 2003

According to the statistics above, during the month of July (which marks the first month of implementing VAT in Lesotho) there were no refunds which were paid out to vendors as the administration was in the process of verifying the tax returns to ensure that the vendors had accurately assessed themselves. Since this was a new process, the administration wanted to establish that all the claims were genuine.

There was no VAT refunded to LRA by SARS in the first month, as appears from the table. The reason behind this is at the time negotiations between the two organisations were on going and agreement had not yet been reached. Further, another reason there were no refunds received from SARS is that since this was the first month of implementing VAT, it is logical to conclude that the invoices would have been forwarded to SARS after the tax period at the end of July. Therefore, any refunds to be paid would be received in the following month.

Similarly, it appears that there was no record of revenue collected from the Import VAT credit facility.²⁹⁹ It was not clear from the report³⁰⁰ whether there had not been any revenue collected from that source or whether the traders' records and invoices were being checked against their VAT returns to ensure their accuracy. Another possible explanation was that the business entities that had applied to be part of this facility were being screened by the administration and the process had not been completed. Therefore, until completion of the screening process, the business entities were not paying any VAT

²⁹⁹ See footnote 273

³⁰⁰ *VAT Division Quarterly report, July –September, 2003 op.cit.*

under the scheme.

The VAT import credit facility constituted one area where the administration had to focus during these first three months of implementing VAT. It appears that the difficulty which the tax officials were faced with during the initial period of introducing VAT with respect to the credit facility was that the information which appeared on the import credit facility statements did not match the payments which were made by the vendors.³⁰¹ This resulted in disputed debit balances which were noticeable on the vendors' accounts as they were reflected by the computer database. Therefore the Division recommended that the tax officials and the importers should reconcile the information on the invoices and accounts submitted to the VAT office with the importers' own records before any payments could be made. This clearly indicates that the importers were not conversant with how the scheme worked and what information and statistics were needed to determine their tax liability. The fact that this was a new scheme which was introduced under VAT meant that this could be expected. The administration therefore, had the task to ensure that the business entities registered under the scheme understood how it worked and were available to assist them at all times.

4.8.3.2 Revenue Collection for the Period Between October and December, 2003

Table 7 -VAT collection between October – December 2003

Collection Stations	October	November	December
RPU	26,229,066.15	32,528,989.55	28,804,591.05
SARS Refunds	13,822,025.86	10,139,572.96	12,537,287.85
DebtCollectionUnit	907,042.59	1,630,464.69	955,999.83
Car Clearance Unit	1,975,551.93	740,970.92	766,713.59

*source – VAT Division Quarterly Report, October-December, 2003

³⁰¹ Interview with the Principal Officer, Return Processing Unit

The first point to highlight is with respect to the various units which collect revenue which is recorded during this period. It seems there were no records of revenue collections from the border posts or from the other VAT offices from the other districts. The report did not give any explanation of the lack of such revenue records. However, a number of reasons could be given for that. For example, it could be a result of the delay in forwarding records to the head office in time for compilation of statistics into the monthly and quarterly reports. Another reason could be that the records and collections made in December are likely to have been received in January 2004, as most business entities close for holidays at that time of the year.

It also appears from the table that during this period there were no refunds which were recorded as having been made to vendors. This can be explained by the fact that the Division was in the process of verifying the refund claims which were lodged with the Commissioner. In practice refund claims usually take longer to verify and to process by the administration. The administration wants to have a reasonable time to check the refund claims from the business entities and if there is need to refer to the invoices. Payment of refunds is one of the controversial issues under the VAT system and this is discussed in chapter 5.

The administrators had anticipated that during this period revenue collection would be higher than the previous period, as they expected that the business compliance level would improve after three months of implementing VAT.³⁰² However, it appeared that there were other reasons which affected the collection of VAT during this period, particularly in December including the following:-

- Firstly, most business entities did not file their returns in December on the date when they were due, since they had closed their ventures for Christmas holidays before the end of the tax period.
- Secondly, it appeared that some business entities use the VAT collected as security at their banks to obtain either bank overdrafts or loans. Therefore, they would prefer to keep the money at the bank and earn interest on it, rather than to hand it

³⁰² Interview with Assistant Commissioner, Taxpayer and Collections Unit

over to the VAT division on the due date. This problem of cash flow seems to be a major problem in developing countries. This indicated that some business entities did not understand how VAT works and the fact that the tax they pay is not necessarily part of the businesses' profits/cash (the same issue arose from interviews held with some business entities in Lesotho). The tax represents money that has been collected from consumers and has to be paid to the government. It has also been observed that some big business entities do not really have a problem with paying a penalty for delaying the payment of VAT, rather than forfeiting the opportunity to get interest from the money at the bank. This indicates that there is to some extent a lack of tax culture and compliance ethics from some of the business entities.

4.8.3.2.1 Focus and Special Investigations of the Division

As a way to improve compliance by the business entities, the VAT Division administration identified three areas on which they needed to focus during this second period of implementing VAT.

Firstly, the Division focused on verifying refund claims which were made by business entities. The objective was to ensure that all refund claims were genuine and were correctly computed. Secondly, the administration focused on those who failed to file their tax returns. This was carried out through telephone calls to those who had failed to file their tax returns and visits to the business premises where it was possible. The findings from these visits revealed a number of issues.³⁰³ The administration discovered that some business entities had closed their businesses; while others were not located by the officials; and there were some entities that had either applied for cancellation of registration or were trading under a different name than the one they were registered under.

The third area of focus was to carry out an inspection exercise of records that relate to items which are zero-rated in South Africa, but taxable in Lesotho. The objective

³⁰³ VAT Division quarterly report October-December 2003

was to ensure that vendors registered in Lesotho, who import zero-rated goods from South Africa, which are taxable in Lesotho do properly declare such goods at the ports of entry and pay VAT in Lesotho accordingly. The operation was only focused in 5 border posts and towns: Butha Buthe, Leribe, Maputsoe, Teyateyaneng and Mafeteng. It can be assumed that the investigations focused only on the mentioned border posts because they are the busiest border posts between Lesotho and South Africa. (The reason being these border posts are also open 24 hours, whereas some border posts close at 10.00pm; and big business entities tend to import and export through these border posts). The investigation revealed that the majority of business entities had not paid import VAT and could not provide evidence that import VAT was paid on the zero-rated goods from South Africa which are taxable in Lesotho.³⁰⁴ It can be argued that this is a serious administrative issue and required effective measures to be introduced at the border posts.

It is clear from the findings of this investigation that there was need for the administration to revisit some issues of implementation of the tax and to carry out visits to the premises of the business entities.

4.8.3.3 Revenue Collection for the Period Between January and March 2004

Table 8 - Revenue Collection between January – March 2004

Collection Stations	January	February	March
RPU	40,240,617.92	31,373,689.72	21,623,103.41
SARS Refunds	10,518,948.80	15,426,385.25	10,900.846.25
DebtCollectionUnit	1,584,559.88	651,383.75	796,158.64
Car Clearance Unit	2,045,994.88	699,673.12	1,036,958.64
Borders	2,669,377.16	2,697,199.76	3,005,754.94
Import VAT	121,473.22	168,219.04	117,057.21
Districts	2,502,405.36	1,806,302.54	1,054,323.27

*Source –VAT Division, Quarterly Report, January-March, 2004

³⁰⁴ VAT Division Quarterly report, October to December, 2003 op.cit.

It appears from the table that the collections in January, 2004 from most of the units, particularly RPU, DCU, CCU, the offices in the districts and VAT collected at the border posts were high as compared to the other months. The explanation would be that some of the collections covered the VAT which was due in December, 2003. However, since some of the business entities closed for Christmas and New Year’s holidays, they failed to submit their tax returns in the tax period in December and failed to pay the tax due. Another possible explanation is that there was an increase in sales in December and January resulting from Christmas and New Year celebrations, particularly by business entities which deal in consumables, clothing, and beverages. Furthermore, there was a lot of movement of taxable goods into the country due to the holiday season.

The other reason for improved revenue collection as compared to the period between October and December, 2003 is the fact that during this period business entities understood their obligations and how VAT is calculated.

4.8.3.4 Revenue Collection for the Period Between April and June 2004

Table 9 - Revenue collections between April – June 2004

Collection Station	April	May	June
RPU	48,842,284	63,616,353	54,775,582

During this tax period there was not sufficient information to make any conclusions on the state of revenue collection from which the various units collected their tax. Efforts to get hold of the information have not been successful. This period constituted the beginning of the financial year (2004/2005) and it can be assumed focus was more on compiling the year’s report for submission to the MOF.

4.9 Challenges of Implementing VAT

The implementation and administration of VAT in Lesotho did not go without any problems or challenges. It appeared from the administration perspective through the interviews which were held and also from the various reports, that there were administrative issues which still needed to be addressed. (Though these issues came from interviews held with the administration, the analysis is based on the principles and practice of VAT system and individual arguments are put forward in that context). The following issues were identified as challenges to the administration of the VAT system:-

- 1 Refunds to Exporters: - refunds to exporters represent a crucial and problematic aspect of any VAT system. The position in Lesotho is that exports are tax free, which means exporters are not required to pay any VAT on goods or products which are being exported from Lesotho. This is in accordance with destination principle. Though exporters do not pay any VAT, they are allowed to claim all the VAT on their inputs incurred in the process of production. Since they do not incur any output tax because they do not supply taxable goods within the domestic market, this means that they are always in credit with the VAT Commissioner. Therefore, this means the VAT Commissioner has to refund exporters the VAT which they have paid in previous stages of production. The administrative arrangements³⁰⁵ with respect to refunds were that the Commissioner-General is the only one who can deal with these refunds. This resulted in delays in the payment of refunds to the exporters. This delay caused great inconvenience to the exporters since they require the refund in order to pay the VAT costs in the country to which the goods are being exported. This was heavily criticized by exporters.³⁰⁶
- 2 Audit capacities: - It appeared that the staff in the audit division was reduced since the administration argued that the ratio of staff was not proportionate to the

³⁰⁵ Interview with the Assistant Commissioner, Taxpayers and Collection, January 2004.

³⁰⁶ Cross refer to paragraph 5.9.2 on Exports and Refunds in Lesotho where this subject is discussed further on the basis of the results from the survey with the business entities in Lesotho

number of business entities.³⁰⁷ This seemed to be one of the concerns of the VAT Division and raised the question as to whether the remaining staff would be able to do their job effectively. It can be argued that in practice an effective and well structured audit program is one of the important components of VAT operation. Where the audit program is not effective, the tax system is at risk. The impact of the reduction of the audit staff within the division can only be established through administrative practice and how well the VAT Division approach auditing of businesses.

- 3 VAT on imported goods from South Africa: - the differences in VAT rates and the treatment of some goods and products (for VAT purposes) in Lesotho and South Africa led to various administrative problems in Lesotho. There are differences on VAT rates which are applicable to certain goods (in particular food items) in Lesotho and South Africa. This relates to food items which are zero-rated in South Africa but taxable in Lesotho. These are cooking oil, rice and tinned fish, which are zero-rated in South Africa but chargeable to VAT in Lesotho. This has led to an increase in smuggling of goods into Lesotho and it means loss of revenue which could be collected from the importation of such goods. This requires the tax officials deployed at the border posts to scrutinize the invoices thoroughly which are submitted by the traders and the consumers on the imports. They also have to carry out thorough checks on the goods. This has resulted in long queues and delays for the business entities and consumers. This is not the best situation for the administration, while they are making claims to the business community and public about the efficiency of the VAT. One option is to amend the law in Lesotho to extend goods which are zero rated to accord with zero rated goods in South Africa as a way to address the problem. The approach which was in fact adopted was to negotiate with the SARS authorities a proposal to align the rates of goods which are zero-rated in South Africa and standard rated in Lesotho. However, it seems there has not yet been any agreement on the issue.

³⁰⁷ Interview with the Assistant Commissioner, Taxpayers and Collection, January 2004

- 4 Sustainability of the data base of the tax system: - another concern for the administration was the sustainability of the data base within the Division. There was uncertainty about how long the computer data base which was in use could be sustained effectively for use for the registration of vendors, assessment and keeping the vendors' information. The administration was concerned with whether the data base can be used over a long period of time or whether there will be a need to change.³⁰⁸ As there is need to plan well ahead of time, and have time to secure more easy-to-use and inexpensive resources, the administration was not sure of the sustainability of what the Division was relying on at the time.
- 5 Government compliance with VAT: - The government is liable to charge and account for VAT under the VAT Act; however, it appeared that the resistance of some of the government's departments to account for VAT remained one of the major challenges to the administration. Some of the government's departments engage in taxable supplies of services and goods, and therefore they are required to comply with the obligations of charging VAT and pay it to the revenue office (this was discussed particularly as part of the challenges of the administration for period between July to September, 2003).³⁰⁹ Some of the reasons which contribute to the government's failure to pay VAT are as follows: - First, the government departments do not handle cash and therefore do not make payments promptly at the end of each tax period. Instead the government operates a system of making payments 'by invoices' and actual payments from the Treasury department normally follow after several months. Second, some of the government departments are not experienced and trained in keeping proper accounts and records; in most cases it is the department which deals with revenue or other payments that possess such skills. Third, under the sales tax regime the government was not liable to pay tax. One can therefore argue that there was some kind of resentment to obligations arising under VAT as the government authorities did not understand why the government activities have to

³⁰⁸ Interview with the Assistant Commissioner

³⁰⁹ *VAT Division Quarterly report*, July-September, 2003, op.cit.

be subject to VAT. It is hoped that this kind of resentment changes over a period of time.

- 6 Refunds to diplomats: - diplomats and certain others are exempted and are entitled to a refund when VAT has been paid. In terms of *section 47* diplomats are exempt from VAT and this exemption is to operate by way of a refund of the VAT paid or borne by such persons. It appeared that in practice the Commissioner delays in paying refunds to the diplomats and this seems to delay and affect some of the charitable projects which they finance in the country. Since this is an issue which affects diplomatic and international relations of Lesotho with other foreign countries and international organisations, the administration has to take appropriate measures and see if the refunds can be processed more efficiently.

4.10 Conclusion

The establishment of LRA marks an important step in tax administration in Lesotho. This chapter deals with the effects of the change of regime from sales tax to VAT and the establishment of a national revenue authority in Lesotho, as a means of achieving effective administration of the tax system. This study does not go into detail in analysing the structure and design of LRA as a semi-autonomous institution. Focus is mainly on the significance of LRA in strengthening tax administration.

The Authority's main task is to improve and strengthen tax administration in Lesotho in order to achieve a stable and efficient tax system, with the aim of improving tax collection. However, the view that I advocate is that achieving the identified task is not necessarily automatic from the establishment of the Authority by itself. There should be commitment from the government, administration and staff. Furthermore, financial resources; human resources and necessary equipment should be made available to ensure long term sustainability of the Authority. Another issue which comes up is the fact that the government through the MOF sets targets for the Authority, in terms of what they should achieve in collection of VAT. This can be a disadvantage, as it can overstretch

the human and financial resources. This also tends to raise a concern as to whether the government's priority is revenue collection as opposed to efficient tax administration in general.

The other significant development which marks the establishment of LRA is the establishment of Advice Centres. These are places where the business community, other taxpayers and the public can obtain information about payment of tax in general and the requirements of the tax laws. Taxpayers can also submit their tax returns at the Advice Centre and make any VAT payments which are due. Brochures and leaflets on how VAT works can also be obtained from this office. The Centre houses officials from different tax departments - VAT, Income Tax and Customs and Excise Tax. This makes it easier for the public and the business community to be served at one place. The first Advice Centre was initially opened within the LRA headquarters. Two more Advice Centres have been established in other parts of the country to serve both the southern and northern districts in June and July, 2005.

Another important aspect which is relevant to the administration of VAT is the approach which is adopted towards the preparatory measures and activities. The administration modalities of implementation should be in place well before the tax is introduced. The normal preparations such as computerisation of the VAT office; training of administrative staff; printing of relevant documents, (for example VAT returns); ensuring recruitment of skilled and capable administrative staff; education and other awareness campaigns of how the tax operates to the business community and the public at large; drafting of clear and simple VAT legislation and regulations. All these should be clearly put in place well in time prior to the coming into force of the VAT legislation.

As summarised by one writer,³¹⁰ the administrative challenges towards the introduction of VAT include the following: (1) appropriateness of the organizational structure to implement VAT successfully; (2) risk of default and fraud; (3) adequacy of staffing levels, systems, rules and regulations, forms and logistical support; (4) knowledge of VAT processes by staff and their competence to efficiently and effectively

³¹⁰ Bakibinga, D.J., "The Introduction of VAT in Uganda: Avoiding the Great Ghanaian Debacle", op.cit. p.58

implement the process without causing undue hardship to the taxpayer leading to revenue loss; and (4) speed of refunds and adequate audits to minimize fraud.

Experiences from other countries have shown that inadequate preparations for the introduction of a VAT can disrupt the existing administration. For example, in Ghana where VAT was repealed in June 1995 three months after its introduction, it became clear that the tax administration must be prepared for the implementation of the tax – the decision as to which body would be responsible for collecting VAT should also be made on time. The problem in Ghana³¹¹ was that the initial decision was that VAT would be collected by the Customs, Excise and Preventive Service (CEPS), until seven months before the tax became effective when a separate VAT Service Unit was established. This led to tension between the two Units resulting from delay of staff transfers from CEPS to VAT Service. Most importantly, there was a delay in the appointment of the VAT Service's governing board which was not in place when the tax became effective.

It can be concluded that the establishment of LRA has taken the administration of VAT in Lesotho further and has proved efficient to some extent. The implementation of VAT and its administration cannot be discussed in isolation from the measures which were introduced to strengthen tax administration in Lesotho. VAT is the responsibility of the VAT Division which is a part of LRA and the Commissioner of VAT heads the Division.

Furthermore, it seems the implementation of VAT in Lesotho has had to deal with two major challenges which are, to achieve efficiency in implementing the legal structure and to concentrate on how to achieve revenue efficiency of VAT. Both these challenges are intended to achieve a stable tax system.

³¹¹ The World Bank Prem Note, December 2001 Number 61 (From the Development Economics Vice Presidency and Poverty Reduction and Economic Management Network) p.1

Chapter 5: Practical Impact of the Introduction of VAT in Lesotho

5.1 Introduction

This chapter analyses the results of the survey which was conducted as part of the fieldwork research carried out in Lesotho from January to April 2004. The chapter begins by setting out the purpose of the survey; what it intends to achieve; its contribution to the research as a whole; and how the survey was structured. The chapter also sets out the planning process of the survey, how the questionnaire was developed and considerations which were taken into account in developing the questions. It also incorporates the methodology of the survey and the criteria which were used to choose the participants to the survey.

The chapter is arranged in the following way: - firstly, it looks at the purpose of the survey, the methodology of the survey, the choice of questions for the survey, the choice of the participants, and the distribution of questionnaires. Secondly, the questions are set out; and a critical analysis of the questions and answers from the questionnaires with reference to academic writings and principles follows (this includes reference to principles which are discussed in previous chapters). The chapter concludes by highlighting, in a summary form, issues which have arisen from the survey and are identified as positive or negative towards the administration of the VAT system in Lesotho.

5.2 The Objectives of the Survey

The main objectives of the survey were to investigate the initial implementation and how the VAT system in practice applies to registered business entities. This included finding out whether the business entities understood the system and knew their compliance obligations within this system. The business community collect VAT from unregistered taxpayers and pay it over to the government. In this way their role is crucial in any VAT

system. Where there is a move from one tax system to another, it is important to find out how the change affects business entities and their obligations. Therefore, it is important to investigate how the business entities view the VAT system.

5.3 Methodology of the Survey

5.3.1 Choice of Questions for the Questionnaire

The questions for the survey were intended to establish whether the move from sales tax to a VAT in Lesotho has been successful and whether the administration of VAT has been efficient since its implementation. The survey aimed; -

- To examine the implementation process of VAT (in Lesotho) in practice;
- To examine the administration regime of VAT; whether the administration problems which existed under sales tax have been overcome under VAT; and whether the administration is effective or not;
- To find out whether VAT has affected imports, exports, prices of goods and services, production efficiency of the business community and whether it has had any impact on the compliance costs of the vendors;
- To find out the views of the end users (business entities and taxpayers) on the administration aspects of VAT, both at the head office and border posts where VAT is collected on imports;
- To get views on VAT as a tax; its effects on business and on small businesses; and on those who may intend to go into business.

5.3.2 Choice of Business Participants

The choice of the sample of business entities which were contacted to participate in the survey was based on the lists of registered vendors from the VAT Division. The lists were divided into various categories, which were by districts; by turnover (those who are above the M500, 000 threshold and those who were below that, but who have opted for

voluntary registration); and registered businesses under the import VAT credit facility. After consultations with the administration about the questionnaire and without breaching the confidentiality requirements of the use of traders' information, the choice of the business entities was influenced firstly, by their size (turnover) to ensure that both big and small business entities participated; secondly, whether they were under the credit input facility scheme, both exporters and importers under the scheme; and thirdly, the type of business venture to ensure some kind of fair distribution amongst different sectors.

The questionnaires were distributed to business entities in the primary sector, manufacturing sector and those which deal exclusively in the services sector. There was no specific number of questionnaires distributed to each sector. Furthermore, another consideration in the distribution of the questionnaires was the location of the businesses and locations which were easily accessible were given first preference. In some parts of the country it is difficult to travel and therefore it would be difficult to reach the traders and collect the questionnaires.

5.3.3 Distribution of Questionnaires

The questionnaires were sent out with two accompanying letters; one from the supervisor and the other one from the researcher. The purpose of the letter from the supervisor was to introduce the researcher. It went on to explain that the objective of undertaking the research was for academic purposes and that the information will be used as part of a research towards the completion of a postgraduate degree with the University of Edinburgh. It went further to request the assistance of those who are chosen to participate in the survey and stated the policy of the University on confidentiality in the treatment of any information obtained from that survey. The second letter was explaining why the study and the survey were being carried out and what was intended to be achieved from the survey. The letter included the contact numbers and address to either call when the questionnaire is completed for collection and postal address in cases where it would be returned by post.

The distribution of questionnaires was done through the LRA advice centre and through personal delivery of the questionnaires to the premises of the businesses. When the questionnaires were delivered to the businesses' premises, the date and time for collection of the questionnaire was arranged with the business management. As regards the questionnaires which were distributed through the LRA advice centre and had clearly been marked for a specific trader, a follow up with a telephone call after 5-8 days was made to arrange the date and time for collection. In some cases, several telephone calls and follow up visits had to be made to check whether the questionnaire was completed. The questionnaires which were distributed through LRA were those where delivery had failed, since the businesses could not be located. Further, some of these questionnaires were unmarked questionnaires so that they could have been handed to any vendor or potential vendor who visited the centre, whereas some of them were addressed to specific business entities.

The total number of questionnaires which were sent out to registered businesses was 120. 60 of the questionnaires were sent to business entities above the threshold. They were addressed to business entities which were chosen to participate in the survey. 20 questionnaires were sent to business entities below the threshold which were specifically chosen to participate in the survey. 40 questionnaires were handed over to the LRA advice centre to hand them out to the traders. Out of this number, 15 questionnaires were clearly marked to traders who were chosen to take part in the survey, but their trading places were inaccessible, for example, most of the textile and manufacturing firms (exporting firms) which are owned by foreign (Chinese) traders were not accessible due to security reasons and some could not be located. As a result I made contact with them by telephone and they opted to pick up the questionnaire from the LRA Advice centre. 25 of these questionnaires were to be handed out to any registered trader who came to the Advice centre (excluding business entities identified above), without necessarily being part of the chosen group from the list. Furthermore, some of the businesses were situated in areas which are not very easy to access due to the distance involved and poor or non-existent roads. In this case, I had to rely on the

fact that the traders would come to the LRA Advice centre to file their tax returns at the end of the tax period.

Out of these questionnaires, 10 responses were received from the businesses which were below the threshold and 4 interviews were held with those who declined to complete the questionnaire. 65 questionnaires were received and collected from other businesses.³¹² 5 businesses from the big business community also volunteered to give interviews to go through their responses in relation to the questions on the questionnaire. This means 45 questionnaires in total were not returned. (Out of this, 16 questionnaires had been sent to specific traders and 29 questionnaires had been distributed through the LRA Advice Centre. Contact was made with the 16 traders who had not completed their questionnaires, through follow up visits and telephones where it was possible.) Some of these traders promised to complete the questionnaires while others said they had sent the questionnaire to the Head office which was based in South Africa, but it had not been returned. Others declined to see me when I visited their business premises and some of those who were contacted by telephone made promises as to future completion. Others still were never available to speak to me. I could not maintain any more contact with these traders from May 2004 as the time available for my fieldwork had expired and I had to travel back to Edinburgh.

5.3.4 Distribution of Responses by Economic Sector and Size

As the questionnaires were being collected and some being returned through the post, I classified the responses according to what type of business venture the trader is engaged in; and the size and turnover of the venture. The distribution of responses is presented in Table 10. (The responses are classified according to the economic sector of the business entities which participated in the survey, that is, retailers and wholesalers sector; manufacturing, construction and textile sector; and services sector.) The responses are further coded according to the size (turnover) of the business.) This distribution

³¹² A total of 79 business entities took part in the survey and the results analysed are based on the completed questionnaires (and interviews with some) from this category of entities

represents all the business entities that are registered, either with a turnover which is less than the minimum requirement or those above it.³¹³ The total number of the business entities is matched with the total number of questionnaires which were completed and returned including the entities that preferred to be interviewed rather than completing a questionnaire.

The size of the business entities is coded in numbers 1-4 with each number representing the following category of turnover: (the turnover is expressed in Lesotho monetary currency)

- 1- 10,000 -----419,000
- 2- 420,000 -----499,000
- 3- 500,000 -----999,000
- 4- 1m -----above

Table 10 - Classification of Business Entities
SIZE

					Total
SECTOR	1	2	3	4	
Retailing & Wholesaling	6	4	8	5	23
Manufacturing & Textile	-	-	6	12	18
Services	6	13	12	7	38
TOTAL					79

Most of the business entities engaged in the retailing and wholesaling sector are those who import most of their goods and items, while some of them deal in domestically produced goods. The manufacturing, construction and textile sector is dominated by firms which mainly export their products; however there are some

³¹³ The minimum turnover is M500, 000 (*Maloti*). This is equivalent to £38,628 at the exchange rate of 1

business entities within this sector that sell domestically only and some who export and also sell domestically. Business entities which are classified under the sector of services provide their services domestically.

5.4 Analysis of the Questionnaire

5.4.1 Format of the Questionnaire

There were 13 questions to be answered. It was optional for a business entity to include its name at the top of the questionnaire. This was to ensure that those entities which were not comfortable with disclosing their name would not decline to participate in the survey. Some firms did include their name, whereas others did not.³¹⁴ For purposes of coding the data and identifying the firm and the business venture it is engaged in, with questionnaires which were collected from the business premises, the names were entered on the questionnaire where they were not included. This was impossible to do with those questionnaires which were returned by post. However the analysis of the questionnaires and responses do not reflect any identification of individual business entities. The analysis and reference is restricted to the principles which arise and the issues have been raised in a general form from the responses to the questions.

Table 11 - Question 1

Question 1: What kind of business (understood to mean business venture) are you engaged in?

A summary of the type of business entities which took part in the survey is presented in Table 10. The table summarises the responses by economic sector according to the characterisation by sector; retailing and wholesale sector; manufacturing and textile sector; and services sector.

loti=£0.077 as at 21st July, 2006

³¹⁴ 37 business entities included their names on the questionnaires and this includes those which were interviewed, while 42 business entities did not include their names

The question was intended to establish the nature of each business entity with respect to the kind of supplies they make, that is supplies of goods; supplies of services or both. The objective was to ensure that the survey is representative and that the firms from different sectors of the economy are part of the survey. All the business entities (75) which returned their questionnaires gave a response to this question. This includes the 4 business entities which gave an interview though they did not complete the questionnaire.

5.4.2 Registration Threshold and Small Taxpayers

Table 12 - Questions 2, 3, 4 and 5

<i>Question 2:</i> Were you required to register under the Sales Tax Act? YES OR NO
<i>Question 3:</i> Are you required to register under the present VAT Act? YES OR NO
<i>Question 4:</i> What is your minimum turnover of taxable supplies of goods and services?
<i>Question 5:</i> If registered and not required by the law to do so, why did you decide to register?

Table 12 sets out questions relating to the basic principles of registration, including the registration threshold for VAT. Two of these questions required either a ‘yes’ or ‘no’ answer, as the traders had to state the facts about their firms with respect to the tax system. The investigation in this regard: - is firstly, the issue of the registration threshold; and secondly, to find out which traders are mandated to register and which have opted to register. This investigation is directed at the principle of voluntary registration for VAT in the context of Lesotho, which is a small developing country whose economy largely comprises small traders and an informal sector. The issue is whether there are small traders that have registered voluntarily to be part of the VAT system and if there are, to examine the reasons why they decided to register. Therefore,

the advantages and disadvantages of voluntary registration by small traders are examined in the context of the position in Lesotho.

Most of the small business entities were not keen to participate in the survey and to complete the questionnaire. There was no particular reason given for this, but a range of different excuses were made. For example, in two cases the owners and managers of the entities said they were busy; while in one of them, I was told the owner was not present therefore, the staff did not accept the questionnaire. From a personal point of view, I thought they were not convinced about the status of the research and whether their business information would not be passed on to LRA. Though, they were assured that this was an independent academic research, it seemed there is a general perception (amongst taxpayers and business entities) that any study or research related to VAT (or other types of ‘tax’) is associated with LRA. However as it is shown in the table below 14 small traders participated in the survey. Table 13 summarises the responses to the questions set out above and the percentage of the responses to each question from the business community.

Table 13 - Responses to questions in Table 12

Question 2: the question was answered by all 79 respondents, to say whether they were required to register or not under sales tax.

Question 3: the answers depended on the turnover of each business entity.

-Yes:- [65]

-No:- [14]

Question 4: the question followed from Question 3 and the objective was to have an idea of the minimum turnover of each vendor. This was also to ensure that the survey is representative and inclusive to all the different types of vendors. The responses which were given in most cases were in the form of estimates (by most vendors) in terms of yearly minimum turnover – [79 responses].

This is summarised in Table 10.

Question 5: was relevant for the business entities which are below the threshold but have decided to register. These businesses' turnover range between M499, 000 to M100, 000.³¹⁵ This was to find out why they have decided to register voluntarily and be part of the VAT system – [14 responses]

Reasons given for voluntary registration (most had more than one reason):-

(1) To ensure that they benefit under the system by being able to charge VAT and to claim input VAT where it is applicable. Since they pay VAT when they purchase from the retailers or producers it will be an advantage for them to claim any credit – [6]

(2) They thought VAT will help them to improve their business affairs in general including the record keeping and books in general. This would assist them to run their businesses efficiently –[9]

(3) They were hoping that in a couple of years their turnover would go up, so they would have acquired experience of being part of the VAT system and how it works-[11]

(4) To be able to compete with other registered businesses. They tend to be of the view that registered businesses are more at an advantage than unregistered businesses in terms of attracting buyers and consumers. Therefore the only way to be able to compete with those businesses in the business market is for them to get registered –[7]

The information from questions 3, 4, and the first part of question 5 was compared with the information provided by the VAT Registration Unit from the registration lists. The registration list from the VAT Registration Unit divided the business entities in different categories for purposes of registration. They were divided according to whether they were under the VAT credit import facility scheme; or whether

³¹⁵ LRA Registration List titled Registered Traders – Turnover less than 499 000 as of 25 March, 2004

they were firms which fell below the minimum threshold; or according to where the firm was located (this relates to the district where the firm was carrying its business). The latter categorisation included all registered firms in spite of the nature of their business or their size.

The main significance of registration to the businesses is twofold; those firms are obliged by the law to charge tax on their sales and they can also reclaim tax on their inputs.³¹⁶ Registration also requires the vendor to comply with various administrative requirements. For example, a vendor is required to keep records, make periodic VAT returns, pay any VAT due to the VAT office and also allow the revenue authorities to inspect its records. Registration therefore, distinguishes firms which are obliged to charge VAT from those which are not.³¹⁷

The liability to register arises for all taxable persons whose turnover is above a particular threshold which has been set by the government. Therefore, the choice and setting of a threshold is crucial to determine when registration for VAT is compulsory. Setting the threshold, the revenue administration takes into consideration a number of factors and the government will have some guidelines in deciding what should be the minimum threshold. Though the administration has to consider the increase of revenue on the one hand, that has to be considered in relation to the collection costs and the compliance costs of the business entities.

In setting the threshold, the administration has to consider its capacity and resources to deal with registered firms. In that way, in order to achieve administrative efficiency, it is best if the available resources are used to focus on a group of large business entities which is able to achieve compliance without many difficulties.³¹⁸ This is why, in most countries the IMF team recommends that, for simplicity, efficiency and

³¹⁶ Keen, M. and Mintz, J., "The optimal threshold for a value-added tax" *Journal of Public Economics* 88 2004 pp. 559-576 (IMF: Washington D.C.) at p.560

³¹⁷ See chapter 3 at paragraph 3.3.8 for the specific registration requirements under the Lesotho VAT system

³¹⁸ Most VAT systems leave out the small businesses outside the system and therefore they are not required to register for VAT. This is justified in that, "a liberal registration policy can lead to administrative problems, because individuals can abuse it by becoming registered, claiming input credits for what are essentially personal-use items and never recording taxable sales (or substantial taxable sales)." – See Thuronyi, V., *Comparative Tax Law* 2003 (Kluwer Law International: The Hague) p.325

transparency of the VAT, a high threshold should be applied and that it should be specified uniformly for all types of activities in terms of turnover.³¹⁹

Another important consideration in setting a threshold is the potential level of distortion of competition between those firms which are above the threshold and required to register; and those which fall below that threshold. This would relate to firms which are exempt and which are not able to claim their input tax from the revenue office since they are not entitled to register. Distortion can also result where a firm which is below the threshold buys from a registered firm and it is not entitled to claim input tax when it sells the item. In this case, the firm may try to recover the tax by increasing the price to the consumer.

It is a well established fact that business entities that fall below the threshold are allowed to be part of the VAT system by registering voluntarily. Voluntary registration is part of most VAT systems around the world. For example it is available for the VAT systems within the EU member states, GST in New Zealand, and the VAT systems in other African countries such as Mozambique, South Africa, Tanzania, Uganda and Zambia. Tax systems however generally do not set a limit of turnover up to which firms (those which fall below the minimum threshold) are permitted to exercise this option. Most entities which are below the threshold or those which supply zero-rated goods have strong incentives to register in the VAT net.

Why would business entities wish to be part of a VAT system voluntarily? As it appears from Table 13, it seems there are various reasons which led to the registration of these entities. The economic benefits of voluntary registration are that the vendor is able to recover input tax on business expenses which are related to making taxable supplies. This is expressed by some writer in the following way: - "a VAT payer may actually receive money from the government, rather than pay it".³²⁰ Furthermore, traders who are registered for VAT in most cases prefer to buy from registered vendors as it is cheaper to do so.

³¹⁹ Ebrill L., et.al., *The Modern VAT*, op.cit. p.122

³²⁰ Morse, G., *Davies: Principles of Tax Law*, op.cit. p.425 para.24-15

In the case of Lesotho, all the 14 small traders who participated in the survey agreed that it is an advantage for them to be allowed to become part of the VAT system. Though they conceded that the compliance costs are high, they thought the advantages of registering were far greater than the costs involved. They did not think that the compliance costs are higher for small business entities than large business entities. On the other hand, it seems voluntary registration can have disadvantages. These would include extra administrative burden, as the business entities have to keep up to date records and make monthly or other periodic VAT returns to the VAT office. They also have to charge and collect VAT on behalf of the government.

This approach of allowing small businesses to opt into the VAT system is viewed by some writers as advantageous to the businesses. Keen and Mintz³²¹ identify two situations where this may be true. The first is where the applicable rate on their sales is lower – by a large enough margin; as compared to that on their inputs. (This will be the case for exporters, in particular, since exports are zero-rated under the usual destination-based form of VAT). The second is where they sell some intermediate input to registered firms, since the tax they would be required to charge on their output will then be reclaimed by the purchaser, but registering would enable them to recover tax charged on their inputs. They also argue that voluntary registration can be significant for new companies, “which may have little or no output tax against which to credit tax on their inputs.”³²²

The Lesotho VAT system in *section 17 (5)* makes provision for voluntary registration.³²³ In Lesotho the businesses whose turnover is below the minimum compulsory threshold and who have opted to register voluntarily for VAT have turnovers which range between M493, 000 to M10, 000. As of 25th March 2004 there were 362 businesses in total in this category.³²⁴ There were 15 businesses which were registered with a turnover of below M100, 000 (as at 25 March 2004) and their turnover ranges between M98, 000 to M10, 000. These businesses which are below the threshold

³²¹ See Keen, M., and Mintz, J., “The optimal threshold for a value-added tax” op.cit. p.562

³²² Ibid

³²³ This provision is discussed in chapter 3 at paragraph 3.3.8

³²⁴ LRA Registration List titled ‘Registered Traders – Turnover less than 499000’ 25th March, 2004

can be divided into two groups which can be classified as “small businesses” and “middle size” businesses (small businesses is used here to denote businesses whose turnover is below M100,000 and middle size businesses to mean businesses whose turnover is below M500,000 and over M100,000).

It appears that in some countries it is not easy to identify clearly ways to separate small businesses from medium businesses and in some cases even from large businesses. This has purely depended on practical considerations in each country. There has been a tendency (in some small as well as large countries) by business entities to fragment, typically within the family of the business owner, as a way of tax avoidance by not reaching the threshold.³²⁵ The tax administrators would have to guard against a situation where there is a clustering of taxpayers below the threshold as a means of tax avoidance through non registration by the businesses.

Voluntary registration does have the effect of extending the base, to capture too many small, low-turnover businesses. The problem could be greater in developing countries where the number of small low-turnover businesses is high. As a result it may nullify the effect of the exemption threshold and jeopardize the very purpose of its setting.³²⁶ For example, the number of small businesses is huge in Lesotho, therefore including them in the tax net would increase the revenue administration costs and yet their revenue potential is expected to be insignificant because their turnover and value added are generally low. The IMF³²⁷ estimates that on average, the largest 10 per cent of businesses account for at least 90 per cent of total turnover; this implies that the administration costs incurred in taxing the whole group of small businesses may well outweigh the potential benefits (in terms of extra tax collection). In such cases the government have to consider the potential to collect revenue from small businesses as compared to the administration costs which are likely to be incurred in collecting the tax.

On the other hand, it is argued that the existence of a lower registration threshold can eliminate the undesirable situation in which many viable small businesses are not

³²⁵ Shome, P., “Tax Administration and the Small Taxpayer” *IMF Policy Discussion Paper*, Fiscal Affairs Department: IMF May 2004 p.13

³²⁶ Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, op.cit. p.29

³²⁷ Ebrill, L., et.al, *The Modern VAT*, op.cit. p.117

obliged to register, possibly giving them a competitive edge over registered firms.³²⁸ This could be true with countries where there are a lot of small businesses which are viable and which have the potential of bringing in a considerable amount of revenue. It could be advantageous therefore to the system in such circumstances to ensure that such businesses are brought within the tax net.

It appears that some writers tend to favour a high threshold to avoid small businesses from being part of the VAT net as they argue that, “a low threshold will result in high collection costs, strain the capacity of tax administrators but provide low revenue potential”.³²⁹ Similarly it can be argued that voluntary registration without a limit is likely to result in high collection costs on the tax administration. Therefore it can be recommended that voluntary registration should also have a limit to ensure that it does not ultimately result in a large number of very small businesses opting to register for VAT. One can envisage a situation where even the small ‘barber shops’ or ‘small cafes’ are all registered though they are not in the position of achieving the minimum threshold at any point in the future. These kinds of firms will register with the hope to gain some advantages from the system. Often they tend to look at the advantages of registration and overlook the disadvantages which exist.

Though it is apparent that there are problems which are related to the inclusion of the small businesses within the tax threshold, it is however believed that small taxpayers should be appropriately taxed for two reasons. Firstly, their potential tax contribution in combination with that of the medium-sized taxpayers can be quite large. Secondly, the effect of ignoring a large amount of potential tax revenue from particular sectors is likely to be significant for the dynamics of economic growth.³³⁰

³²⁸ Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, *op.cit.* p.51

³²⁹ *Ibid*

³³⁰ Shome, P., “Tax Administration and the Small Taxpayer”, *op.cit.* p.4

5.4.3 Registration of Small Businesses and Problems

Small traders, especially those who deal with cash sales without using tills, (cashiers) find it difficult to keep records of their gross takings.³³¹ This for example would refer to the small shops, 'tuck shops', 'carry outs', street vendors or market traders. In respect of the small traders who participated in the survey, they all had cashiers within their business premises. However some of the cashiers did not have a till roll for receipts, which would enable them to know their exact gross takings each day; while others were not in good working condition. They had to rely on the physical counting of their gross takings and calculate that against their stock takings. Since most of these small businesses dealt with final consumers who mostly do not request or require a receipt or an invoice, it is normal for them not to have any paper roll for their cash machines. In respect of the small businesses that are actually registered for VAT in Lesotho, the businesses which were visited did issue receipts and invoices to the customer when the customer only requested such a receipt. However, they did keep their own receipts of all the cash transactions. It is common practice for small traders in Lesotho not to keep any records of their daily activity as they deal with cash sales.

Small traders also have problems with multiple rates of VAT. Since there appears to be no VAT system with only one rate, this could be a problem in a number of countries. As noted above, small traders may find it difficult to keep records of gross takings and even if they can do so, they may often find it difficult to split their sales between sales liable to different rates of VAT.³³² For some of these businesses bookkeeping may not be an easy task. In Lesotho for example there are four VAT rates. Therefore business entities have to keep separate records and they might find it difficult to separate their sales according to these different rates. For example some of the small businesses sell both zero rated and standard rated goods, such as maize meal and paraffin which are zero rated, but also sell items such as biscuits and tinned food which is standard rated. These businesses did acknowledge that they encounter problems in

³³¹ Tait, A.A., *Value Added Tax: Practice and Problems*, 1988 (IMF: Washington D.C.) p.113

³³² Ibid, p.114

keeping the records for the different sales and they thought that separating the sales for the different tax rates increased their work load and was also complicated. The managers and owners of these small business entities usually lack specialist skills in areas such as tax law, accountancy, and financial management which are essential to understanding the obligations of a VAT. As a result they are not able to cope with the multiple demands arising from VAT.

The other common practice with small traders is that in most cases they deal in cash transactions. It is common for small traders to pay for their purchases in cash with takings out of the cash machine. Most of these traders do not keep records of such cash transactions and this distorts the VAT record of both inputs and sales. In Lesotho these types of small family businesses are quite popular and trade in most cases in bars; mini markets; shops; and mini restaurants. The survey revealed (and it was also conceded by some of the businesses) that some businesses do not issue receipts to the customers, unless the customer requests the receipt. Therefore with the strict requirement of invoice based VAT, which demands that sellers should issue invoices for purposes of tracing the transaction, it can be difficult for the small businesses to keep up with this demand.

In practice most small traders tend to consume part of their own stock. It is common that they do not invoice or record these transactions. These self-supplies are a taxable transaction under VAT and tax should be paid on them. However, as some academics argue “it is difficult to enforce charging VAT on self-supplies”.³³³ This does constitute a problem for the small traders since most transactions do go unrecorded. This was acknowledged by some of the small businesses from the survey. It appears that this mostly happens where they deal in consumable products such as standard rated food items and items like mobile telephone top-up cards. It may be mentally difficult to invoice self-supplies, it does not seem practical for traders to make a distinction between their ‘family’ expenditure and the ‘business’ expenditure.

³³³ Ibid, p.118

The scale of the problems of the small businesses is likely to differ from country to country³³⁴ depending on the conditions which exist and how they are treated, but the problems outlined above represent some examples of the problems of these businesses particularly in developing countries.

In practice it seems that studies which deal with issues of small business entities and their registration under a VAT system concentrate in general on the compliance costs of these entities. Therefore, most studies tend to ignore the benefits which small business entities can derive from registering for VAT. Two major benefits can be identified which result from administering the tax: firstly, a cash flow benefit can arise from business activities' access to the VAT paid by customers during the month (and the 28 days given after the month to file tax returns) before the tax is due to the VAT office at the end of the tax period. This means that effectively the business entities benefit from keeping the VAT cash for a period of about 8 weeks without having to pay any interest. They benefit from the interest which accrues on the money in the bank or charge interest for late payment to their own buyers. During this period they can use the money as security to get a loan from the bank or any building society or use the money to cover the staff salaries or other benefits in cases where the business turnover is not sufficient to cover the necessary expenses.

The second benefit for business entities is the managerial and VAT skills benefit.³³⁵ As a result of the training and subsequent practice the manager or owner of the business entity acquires managerial skills and basic accounting skills. This extends to the other members of staff where they are involved in the training schemes and in

³³⁴ For example, in the UK a large number of the small and medium - business entities are owned by members of ethnic minority groups (Hansford, A., Hasseldine, J., and Howarth, C., "Factors affecting the costs of the UK VAT compliance for small and medium-sized enterprises" *Environment and Planning C: Government and Policy* 2003 Vol.21 pp.479-492 at p.480) and for some of the owners (and employees) of these firms English is not their first language and this can increase the burden and costs of compliance. In such circumstances, the language can be a barrier to effectively comply with the obligations and requirements of VAT. These business entities have to get assistance from an accountant or a tax expert and have to incur costs towards payment of their services. In contrast, in Lesotho the small business entities are mostly owned by local people, while the medium-business entities are owned by both foreign business people

dealing with VAT generally. They acquire bookkeeping skills and accounting skills which can enable them to progress to training courses at a higher level. Generally, the VAT experience subsequently provides business entities with much better information and knowledge. This improves their decision making and their approach to VAT.

The advantages of registering for VAT by the small business entities were also acknowledged in Lesotho by these entities and it also emerged from the survey that some of the business entities registered for VAT in order to gain bookkeeping skills and training on how to deal with VAT.³³⁶ Furthermore, some business entities did acknowledge the fact that they do benefit from keeping the VAT (money) prior to paying it over to the government and this worked as an advantage for them.

5.4.4 Conclusion

It seems from the discussions on the principle of registration of VAT and setting a threshold, the most widely acceptable view is that a high threshold should be set in order to avoid the situation where a lot of the small taxpayers will be obliged to register. This view is part of the argument that “low thresholds generate unintended compliance and administration problems and ultimately threaten the sustainability of the whole VAT system.”³³⁷ However, since “a threshold varies across countries, depending on the stage of development, capacity of tax administration and tax culture of a particular country”,³³⁸ there will also be differences in relation to an option given to small traders to register voluntarily. Where such a principle exists, the administration should develop strong mechanisms to monitor the progress of such taxpayers in complying with the requirements of the system. This would include monitoring the pace at which these taxpayers graduate from below the threshold.³³⁹ Similarly, taxpayers who gradually fall

³³⁵ Godwin, M., and Sandford, C., “Simplifying VAT for Small Traders” *Accounting And Business Research*, 1983 pp 279-288 at p.280

³³⁶ See Table 13

³³⁷ Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, op.cit. p.29

³³⁸ Ibid, p.51

³³⁹ Shome, P., “Tax Administration and the Small Taxpayer”, op.cit., p.29

below the threshold and the pace at which that happens should also be monitored and reported accordingly by the administration.

The administration should put in place mechanisms to guard against any kind of avoidance which is likely to occur in this respect. For example, administrators should monitor closely small traders who will deliberately keep the business small in order to avoid registration. In the same way there may be a misrepresentation of a business which has a turnover slightly over the minimum threshold as smaller than it actually is, as a way to avoid registration and payment of VAT.³⁴⁰

Lessons to be learned from other developing countries are that in situations where the threshold is set too low and the tax administration too is weak, the VAT system is likely to encounter problems and be easily undermined. For example, the failure of VAT in 1995 in Ghana provides a good example. The threshold in Ghana was set at 25 million *cedi* or \$20,000 and this was regarded as low,³⁴¹ since in addition public education had not been extended to the small traders and consumers. In the same way the near failure of VAT in Uganda (1996) is in large part attributed to a low threshold, which was immediately increased from \$20,000, which was set at the time of introduction, to \$50,000.³⁴²

5.5 Submission of VAT Tax Returns

Table 14 - Question 6

Question 6: Since July 2003, how often have you submitted tax returns and made payments of VAT to the VAT office?

Responses: The answers varied from every month to specific numbers of times, either 7

³⁴⁰ Godwin, M., “Value Added Tax in the UK: Identifying the Important Issues”, op.cit. 40 at p.241 note 18

³⁴¹ See Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, op.cit. p.30

³⁴² See Ebrill, L., et.al., *The Modern VAT*, op.cit. p.114

or 9 times up to the time of the survey. This would normally depend on when each particular vendor registered for VAT. It is only after the vendor has registered that they are obliged to submit tax returns and pay VAT which is due.

-19 vendors had not filed any returns at the time, as they had just registered;

- 8 vendors had only filed their returns 5-6 times;

-15 vendors had filed their returns 7 times;

-37 vendors had filed their returns 9 times;

The position in Lesotho is that vendors are required to file their tax returns twenty days after each tax period.³⁴³ *Section 37 (1) (a)* further provides that the tax which is due has to be paid by a vendor on the date the return is to be filed. This means that the tax return and tax which is payable are due at the same time, except where an assessment notice was issued to the vendor where the tax is due and payable on the date specified in the notice of assessment. Further, in any other situation which does not fall within the two situations, tax is due on the date the taxable transaction occurs.

At the time the survey was being carried out some business entities had just registered therefore they had not yet submitted any tax returns nor made any payments of VAT to the tax authorities. The survey was carried out 6 months after VAT was introduced. Therefore, some of these entities were in the learning process of how VAT works, how it is calculated and how to complete the invoices. Therefore, though some of the entities might have registered before the tax was implemented, it can be assumed that it took them a few months before they could submit any tax returns. Furthermore, some of the business entities may have not submitted any tax returns as a way to postpone payment of tax and to benefit from keeping the tax money. On the other hand, since there were still concerns about administrative efficiency it can be assumed that some of

³⁴³ See chapter 3 at paragraph 3.3.11.1 where the rules relating to Tax period are discussed

these business entities were taking advantage of this and were merely waiting for the administration to serve them with an assessment notice.

The requirement to file tax returns is an essential feature of a “self-enforcing” tax. The principle relies on the business entities to maintain records and accounts of all the transactions for the purpose of their VAT obligations. Therefore, if the business entities are able to cope with that responsibility, it can be argued that they can be able to undertake and fulfil their obligations under a self-assessment system without any difficulties. It has been argued that, where that is the case, it “shows that they do have the skills and capacity to handle the self-assessment nature of VAT.”³⁴⁴

This is true where the VAT system has managed to eliminate the small businesses from the tax net by setting a high threshold. There can be problems which are likely to arise with this principle of self-assessment. For example, these can include situations where the business entity is in the practice of under reporting its sales and does not wish to disclose fully its true taxable transactions. This would be problematic since the entity reduces its tax liability. (This problem of under reporting was one of the concerns which were raised by some vendors in Lesotho. They believed that some (other) business entities were under-reporting their sales and cheating the system. (However there was no substantial evidence brought forward). They regarded the practice as unfair and proposed that the tax inspectors should go out regularly to carry out inspections of the business entities at their premises.) This concern tends to challenge the administration of VAT in the sense that if there is under reporting of VAT by business entities, this has a severe impact on revenue collection. Furthermore, where there is a concern of cheating the system by business entities, the administration has to ensure that it deals with the issue through investigation, since this factor can influence other business entities to do the same and this can affect the efficiency of the administration overall.

³⁴⁴ Ebrill, L., et.al., *The Modern VAT*, op.cit. p.140

Another important point which is relevant to the issue of effective completion of tax returns and filing is the distribution of tax returns to the business entities. It is important that the tax returns forms are easily available for vendors to complete them in time at the end of the tax period. In cases where the returns are sent by post as it is the case in Lesotho, two to three weeks should be allowed for the tax returns to be received by the taxpayers. However where the post office system is not reliable, this increases the costs of the taxpayers, since they have to travel to the nearest revenue office to collect the return and have to travel back again for purposes of filing and payment of VAT which is due.

It was observed during the internship with the LRA that most business entities did collect their VAT returns from the LRA Advice office and yet the VAT officers submitted that the returns had been sent by post. It appeared that some entities did not receive the returns posted to them. They were issued with 3 sets of returns for the following 3 tax periods. It can be argued that this administrative arrangement was adopted to avoid the costs of sending one tax return each time; and it allowed the VAT office to have time to print and compile the returns. With time and resources permitting, it might be worth looking at other options of distributing and filing tax returns, for example making tax returns to be available electronically to business entities that have access to the internet. This could be connected to the central VAT administration system. Further, the revenue administration might also wish to review the filing period, that is, rather than for filing to be every calendar month, it could be every three months, as this will allow a reasonable time to the business entities to collect the tax returns and return them on time. The establishment of more Advice Centres in other parts of the country can also be helpful as the business entities can collect tax returns at a place not too far from them and can also improve the filing of the returns and payment of tax.

The revenue authorities need to concentrate more on the mechanisms to improve administration procedures to ensure efficiency. Tax administration is significant for the effective implementation of the VAT system. This would also contribute to a favourable perception of the tax administration by the traders and the other taxpayers as well. In cases where the traders have to travel long distances in order to obtain a tax return and to

submit it, it can be tempting for them to delay filing the returns and this can even lead to tax evasion.

Officers which are based in the districts should have a mandate to issue tax returns to the business entities. They should not only be printed and distributed by the head office in Maseru. Alternatively, printed tax returns should be sent out to the offices in the districts for them to distribute to the vendors. A new system was introduced in Lesotho to address the problem of people travelling from the other districts to pay VAT or collecting tax returns from the head office. One officer from the VAT Division each tax period (every month) is sent out to the various districts to assist the vendors in all VAT matters including checking whether the tax returns are completed correctly and also to collect VAT which is due. This should assist in the efficiency of administration.

5.5.1 Conclusion

VAT administration is heavily dependent on the self-assessment principle.³⁴⁵ For the efficiency of the VAT system the administration relies on self-assessment by the registered business entities and the correct completion of the returns. It is also crucial to the system to keep the invoices issued in different transactions, particularly for determining refunds and in case the Commissioner might wish to make reference to them. In this way it is easy for the tax authorities to cross-check the recorded transactions on the returns. In practice there is a possibility of fraud in relation to false refund claims, even with the use of invoices as proof of a taxable transaction. Therefore it is incumbent upon each administration system to set up measures to deal with such challenges and to ensure that submission of VAT returns is effectively carried out by the vendors. One of the ways which has been favoured to reduce fraud is the submission of returns monthly, as any under reporting or concealment can be detected easily. Furthermore in countries where returns are made monthly the amounts of VAT at stake are reduced as compared to where the returns are made quarterly.³⁴⁶

³⁴⁵ Warren, N., "The UK Experience with VAT", *Revenue Law Journal* 1993 Vol.3 p.75-99 at p.84

³⁴⁶ Godwin, M., "Value Added Tax in the UK: Identifying the Important Issues", *op.cit.* p.244

5.6 Costs of the Changeover of Systems

Table 15 - Question 7

Question 7: Were there any significant compliance costs experienced by your business in the changeover from GST to VAT? Is the administration burden any simpler under VAT for small businesses? **YES OR NO** (the businesses could answer 'yes' or 'no' to both questions)

-YES:- [18]

-NO: - [47]

-Not Applicable:- [14]

Can you briefly but clearly set out the costs under both tax systems?

The first part of the question proved to include too many issues and points. This became apparent when the questionnaires were returned by the business entities. It seems the question was not clear enough to the businesses and caused some kind of confusion, as they did not provide answers to the two different parts of the question. Therefore, the results are interpreted on the basis that the responses received relate to both questions, as the same answers could both be attributed to either question. However, this means it is not possible to allocate the exact number of businesses and their responses to each question. Therefore this is acknowledged as a shortcoming of the study.

The responses which are coded under 'Not Applicable' are from business entities that were not registered under the sales tax. In that way they had no experience of compliance costs under that system and under the changeover to VAT.

The objective was to find out whether the change from sales tax to VAT has brought any significant changes to the businesses' compliance costs. It can be argued that the costs are likely to have been particularly higher during the first few months

when the businesses were moving from one tax system to another. The costs can be attributed to acquisition of new stationery for bookkeeping and auditing; acquiring invoices; changing the pricing of the items to include the new rates and paying an accountant to advise and deal with VAT matters in general. This was found to be true in relation to the 'medium size' businesses that were on the border line of the threshold, but would at the same time benefit from registering for VAT. Though no figures were produced by the businesses for the costs before the transition period, they argued that there had been an increase of costs after VAT was introduced. This increase in the costs can be attributed to the administration burden on businesses. Where the administration burden is simpler the compliance costs are likely not to go up. The business entities were expected to indicate the costs they incurred under the sales tax and set out the costs which they have incurred since VAT has been in operation. However, some of the businesses ignored this part of the question and did not set out the costs they incurred under sales tax and the costs they have incurred under the VAT system.

The big businesses are more likely to cope better with the demands of the system rather than the small businesses, as they have better resources and bookkeeping experience of their purchases and sales. These firms also have the experience to deal with the revenue administrators under the sales tax regime and they know what to expect from them. Where the small businesses have registered voluntarily, complying with VAT requirements is more likely to raise their compliance costs. These costs will be towards hiring more staff to concentrate only on VAT compliance.

5.6.1 Conclusion

Compliance costs are likely to go up for some businesses in the changeover from one system to another. However this position is likely to change over time once the businesses have put into place the necessary mechanisms such as regular bookkeeping and auditing and devoting an accountant or other members of staff to handle the VAT issues. This could also be improved by keeping the legal and administrative procedures

simple and clear so that the vendors will not have to refer to the accountants and lawyers all the time to interpret the procedures for them.

5.7 Effect of VAT on Prices

When a new tax is introduced there is always a concern on what the effects of the tax will be on prices. The consumers would like to know that they are not going to pay more tax on goods and services; similarly the business entities are interested in finding out about the effects of the tax on both imports and exports. Business entities are also interested to know whether the tax is going to affect their prices when they purchase from other vendors such as manufacturers, wholesalers or retailers. In addition the business entities are interested to know the effects of VAT on the prices when they sell either to other vendors or to consumers. Similarly the government is interested in encouraging efficiency and the distributional impact and the long term potential of the tax to raise revenue.³⁴⁷ Where the rate of VAT is exceptionally higher than the rate at which the previous tax was implemented, it would certainly result in increases on prices of goods and services to the ultimate consumer.

Table 16 - Question 8

Question 8: What has been the effect of VAT on your prices? (include both goods and services taxable at different rates and zero-rated items) The objective of the question was to investigate whether there has been an effect on prices of the vendors either when they buy or sell goods or provide services. This refers to whether there has been any price increase as a result of VAT on the vendors' own taxable items or whether they have experienced such price increase when they were purchasing any taxable items from other vendors. The question is relevant to the vendors who buy their goods from other registered firms in Lesotho and also make supplies of taxable goods or services either to

³⁴⁷ Tait, A.A., Value Added Tax, 1972 (IMF: Washington, D.C.) p.71

other registered firms or unregistered firms or final consumers. It is more relevant to retailers as their position in the production process is such that they have to buy goods from manufacturers and have to supply them to either other retailers or to unregistered vendors or final consumers. The question is less relevant for vendors who are manufacturers as they import raw materials (and other products) from outside Lesotho and subsequently export their manufactured goods.

Responses to this question are summarised and coded as numbers 1-5:

1- refers to responses that prices have increased by at least 4 per cent after VAT, which is mainly passed on to the consumers – this was a response given by businesses in regard to buying their goods. They acknowledged that they will pass the burden to the consumers when they subsequently sell to them - [27 responses]

2- refers to answers that there is a difference of prices because most retailers cheated in the sales tax system – this concern was mostly given in relation to when the business entities were importing into Lesotho and subsequently selling to other registered vendors or consumers - [14 responses] The business entities held the view that under the sales tax system some business entities undermined the system and did not include the sales tax in the prices of taxable items. Therefore, this has resulted in the difference of prices of some items under the sales tax system and the VAT system in the sense that since VAT is easier to police most vendors are bound to include the tax in the prices of items compared to the previous system. Furthermore, the business entities argued that since there was smuggling of imported goods and cheating at the border posts, such goods were sold at a lower price under the sales tax system, whereas under the VAT system the administrative mechanism have slightly improved and also inspectors ensure that taxable goods are taxed accordingly. Therefore, this is bound to result in a price difference for goods under the two systems.

3- relates to responses that prices have not increased since the business entities have absorbed any additional costs (as some products would be too expensive for the clients)

–this was in relation to when the entities were selling - [6 responses]

4- denotes responses that there has not been any effect on the prices as VAT has got nothing to do with the businesses' prices as it is not a business expense – [26 responses]

5- refers to answers that there has not been any effect on prices, the only difference has been on the Government departments and Diplomats who were not taxed before – [6 responses]

Sales tax was levied at the rate of 10 per cent whereas VAT is introduced at the rate of 14 per cent. Hence the prices in relation to taxable transactions on items chargeable at 14 and 15 per cent were certainly affected as they were previously charged at 10 per cent. However some goods and services are now classified as zero rated or chargeable to a reduced rate of 5 per cent, which never used to exist before. (This can be viewed as an advantage to consumers and business entities that trade in zero rated items). This means that with respect to these items VAT resulted in reduction of the prices.

It can be submitted that to establish the price effect of the introduction of VAT on different taxable products, it is important to identify specific attributes causing the price increase. This needs to be approached with care as there are other factors which can have an impact on the increase of prices apart from the introduction of a VAT.

5.7.1 Conclusion

Economists have argued that as VAT is levied in the same manner as sales tax there is likely to be no substantial effect on prices by VAT. (This is the case where VAT replaces a general sales tax). They argue that under both taxes the consumers are the ones who really bear the burden of the tax (not the businesses) and as they are both general taxes, consumers have no option of transferring to non-taxed goods or

services.³⁴⁸ Consumers will only benefit from those items which were previously taxed but are zero-rated under VAT. However the majority of the business entities in Lesotho confirmed that they did adjust their prices to include the 4 percent increase in tax. It was also not clear whether the increase of tax had been applied to the original price or whether the business entities applied VAT to prices that included sales tax.

It is thus important for the administration to see that the business entities adjust the prices of the items accordingly, to ensure that they do not incorporate both the sales tax and VAT. It is further important to monitor the adjustment of prices on those goods which under VAT are now zero-rated or are taxed at zero-rate (or exempted). Some business entities conceded that their prices did not necessarily increase except the inclusion of VAT. It can be concluded that the tax did result in higher prices in most instances. Relevant statistics to establish whether there was an increase on prices and a significant difference between prices under sales tax and VAT were not available from the revenue authorities.

5.8 Effect of VAT on Business Activity (including Production Process)

Table 17 - Question 9

Question 9: What has been the effect of VAT on your production process?

The responses are coded and grouped into numbers **1-5**.

1- denotes answers like ‘no effect; not much impact on production process; question not applicable to the business since the business does not produce anything; did not change anything; no effect since VAT is not part of our business costs; no records available yet’
– [43 responses]

³⁴⁸ Tait A.A., *Value Added Tax*, op.cit. p.77

2- answers which indicate that production is now cheaper as a result of the tax credits available and that VAT has given them an advantage on input tax – [10 responses]

3- relates to answers that production has increased – [6 responses]

4- denotes answers to the effect that VAT has slowed down production or production has gone down as a result of VAT – [9 responses]

5- answers which have gone further than answers in 4 above, to explain that ensuring invoice compliance has resulted in delays in delivery. Invoices sometimes need to be requested from suppliers where they have been lost by courier services in the process of delivery of products or where they do not comply with the requirements of the VAT law – [11 responses] –Some vendors purchase their goods from South Africa - for example, those who sell computers and accessories purchase them from South Africa. In most cases delivery of both the goods and as well as invoices is by courier service. Since they have to show the invoices at the border posts upon importation of the goods, where an invoice is missing the vendor has to pay VAT immediately or be required to send an invoice to the VAT office. If the invoice is lost and not passed on to the buyer, it is difficult for the buyer to calculate the value added on their own production. Further, waiting for the invoice affects their production as they have to delay their own supply of goods.

The answers which are coded 4 and 5 both indicate significant effects on production and on administration.

This question was intended for business entities which are in the production process. This includes export manufacturers and businesses which are producers for the domestic market. In theory VAT does not affect the costs of production and does not distort the pattern of production.³⁴⁹ As the rate of VAT has gone up by 4 percent as

³⁴⁹ Bannock G., "Reforming Value Added Tax", *Economic Affairs* 2001 Vol.21 No.2 pp.33-39 at p.33

compared to sales tax, for businesses which are in production, there should have been a slight effect of the tax when they buy the production goods and have to pass the tax to their customers who purchase the goods. In this way they could decide to include the 4 percent in their goods for consumers to pay or decide that the firm should maintain its prices. This means the firm bears the costs in some other way. The other issue which arises from the survey relates to administration issues with respect to the impact of VAT on the business activity and production process. This appeared particularly as a result of the administration requirements of VAT which relate to the submission of supporting invoices when claiming credit of input tax. Since such a claim cannot be dealt with unless there is a supporting invoice, the businesses responded in a manner which appears as 'code 5' in Table 17. In such cases, it means the vendor has to wait for the invoice from the supplier before further dealing with the goods supplied.

This question was aimed at finding out whether VAT might have had any impact on the business activity, which results from the fact that the basic VAT rate is now similar to the one in South Africa. Therefore, those who purchased the goods and items produced in Lesotho now bear similar rates of tax. Therefore, some of the retailers and consumers may get their supplies from South Africa, whereas when sales tax was in place, the basic tax was lower in Lesotho than in South Africa. Whether this could in itself serve as a disadvantage to producers was not very clear from the responses given in the questionnaires.

5.8.1 Conclusion

The issue as to whether VAT has any impact on the business activity tends to raise important issues which are relevant to the administration of the tax. It is a requirement of the tax that invoices should be passed between sellers and buyers (registered for VAT) in the production process as proof of payment of tax. An important point is raised by the business entities - that in practice, particularly in relation to imported goods, where the invoice is not passed on time, or lost not by the supplier or the buyer, but by a third person in the process of distribution, this affects the buyer in its ability to calculate its

own value added when such goods are subsequently sold. This tends to affect the business activity of these entities. Though this tends to affect the compliance of the business entities rather than the administration, it can be argued that where the business activity is more efficient it will result in an effective implementation of the system. This implies that the administration in such circumstances could allow the business entity to submit a return and a claim while they are awaiting the invoices.

5.9 Has VAT Affected the Level of Imports and Exports in Lesotho? The Issue of Refunds in Lesotho

The treatment of imports and exports depend on whether a country has adopted a destination or an origin principle. This regulates the cross border trade transactions and how VAT is charged to such transactions.

The objective behind Questions 10 and 11 is to examine whether VAT has any impact on both imports and exports, with specific reference to the treatment of imports and exports between Lesotho and South Africa. Due to the geographical situation of Lesotho, the only significant movement of goods (and services) which takes place into Lesotho is from South Africa. Therefore reference to issues arising in this part will mainly reflect the position between these two countries. The question dealing with imports and summary of responses are shown in Table 18, whereas the question which deals with exports and responses from the survey appear in Table 19.

5.9.1 Imports and VAT in Lesotho

Table 18 - Question 10

<p>Question 10: Has there been any effect of VAT on the level of your imports of goods and services from other SACU countries? Has your level of imports declined or increased or have there been any other changes? If there has been a change, why do you think this has happened?</p>

Responses: coded with numbers 1-6

1- relates to those responses given by businesses which indicated that the question was not applicable to the nature of their business ventures as they did not import anything or no records are available yet – [18 responses]

2- relates to responses that there is no change to their imports – [10 responses]

3- denotes responses that there is no change to their imports; and the import credit facility has helped a great deal in this respect on cash flow; and noted that the arrangement between LRA and SARS of claiming VAT has been significant to the business activities of their firms – [14 responses]

4- identifies those responses which said the changes which might have occurred could not be said to be a direct result of VAT – [7 responses]

5- denotes responses which said their imports actually increased for some as there is no double taxation of goods previously taxed in South Africa and taxed again in Lesotho – [12 responses]

6- relates to responses that there has been a decline in business for a number of reasons outlined as: - the general decline in business in the country; the cheating at border posts by other importers (this acts as a disadvantage to the competitors); the newly introduced administrative procedures by LRA; the increased tax base which has now included services as chargeable to VAT which used to be outside the scope of sales tax. This has therefore had effects on prices (an increase of 4 percent) – [18 responses]

The number of traders who hold the view that VAT has caused a decline of business and has had an impact on imports is significantly high as identified by responses '**coded 6**'. This could be attributed to the fact that generally when a new tax is introduced there is some kind of resentment. Therefore, in the same way some vendors

in Lesotho attributed the decline of business to the introduction of VAT, though this might be attributed to other economic factors in the country. The biggest concern seemed to be towards administration of the tax, which most vendors thought to have moved from bad to worse as compared to the administration of sales tax. It appears that there was a great concern about the administrative procedures and their implementation by the revenue administrators. This could also be attributed to lack of trust of the administration by the vendors.

There are three divergent positions which seem to emerge from the issue whether VAT has had any effect on imports. These are; - that VAT has had no effect on the imports; imports increased due to the alignment of rates with South Africa and thirdly that there have been a decline on imports and business in general due to problems of administration of VAT. It is clear that the majority of the business entities thought VAT has had no impact on their level of imports, but highlight the administrative procedures introduced for charging VAT at the border posts. There was agreement that due to the introduction of VAT at a higher rate of 14 per cent as opposed to the previous 10 per cent, the 4 per cent amounts to an increase, but does not necessarily affect the pattern of importing of taxable goods and services.

Another point which emerges and which is supported by a significant number of business entities as the responses indicate (**coded '3'**), is the fact that importers and business entities no longer have to pay for tax at the border posts immediately upon importation, where there is proof that VAT has already been paid in South Africa. They are required to submit their invoices to show that VAT has been paid in South Africa to the revenue officials of LRA at the border posts. This means these importers no longer have to wait for long hours to pay the tax. Therefore, this shows that the VAT system has to some extent improved border procedures and this is as an advantage in the administrative aspect of the system.

Another significant point is the introduction of the VAT credit facility scheme, which allows business entities that are registered under the scheme to postpone payment of VAT (where it is charged) on their imports to the end of the tax period. This gives them the opportunity to import goods without making payment of the tax every time

they import. They have to submit invoices and complete relevant forms to enable them to make payment at a later stage. This is intended to make compliance easier for such business entities since they can complete all the procedures at one time, which is at the end of the tax period. Therefore, for some business entities this has been an incentive to increase their imports. Furthermore, it can be argued that the VAT credit facility scheme can contribute to reduce the level of corruption on the side of tax officers in the sense that the level of cash (money) handling by the officers has been eliminated to some extent. The present position is that they mostly deal with invoices and completed forms, rather than cash. This is a significant point which contributes to the efficiency of the system.

5.9.1.1 Conclusion

Most of the VAT in developing countries is collected on the imports - “revenue collected on imports commonly accounts for a large proportion of total VAT revenues.”³⁵⁰ The reason is that there are a lot of imported manufactured and processed goods which come into the country which are chargeable to VAT. It is also more effective to collect VAT on imports as it is collected at the border posts when the goods are brought into the country and it is easy for the administration to check them at that point and charge tax. This means that the control and administrative procedures should focus more at the points of import to ensure that VAT is effectively charged. This is more significant for countries which rely heavily on imports like Lesotho. This appears to be the case in other developing countries, as Table 19 indicates. (The interpretation of the statistics in this table needs to be treated with care, since the IMF omits to indicate the total revenue collected during the period when the statistics on the VAT on imports is indicated). The survey was conducted in 1998.

Table 19 - Proportion of revenue collected from imports in developing countries

<u>Country</u>	<u>VAT Revenues Percent(fraction of net)</u>
Albania	60
Bangladesh	64
Benin	58
Bolivia	70
Bulgaria	51
Burkina Faso	43
Cameroon	43
Gabon	51
Ghana	50
Guinea	62
Haiti	70
Jamaica	47
Kyrgyz Republic	30
Mauritania	66
Mauritius	60
Pakistan	64
Peru	40
Philippines	44
Russia	17
Togo	68

³⁵⁰ Ebrill, L., et.al., *The Modern VAT*, op.cit. p.49

Uganda	58
Zambia	67

*Source: IMF staff calculations – Ebrill, L., et.al. *The Modern VAT*, op.cit. p.50

The table indicates that in developing countries there is a significant proportion of VAT revenue which is collected from imports. It can be argued that in most developing countries it is easier to regulate imports at the point of entry (border posts) for customs control. Therefore, it seems these countries tend to focus more on the collection of VAT at this point. This means they have to invest more resources towards administration of tax at the borders or points where import VAT is collected.

Effective administrative procedures should on the other hand be simple and eliminate complicated clearance procedures which might result in long queues or waiting period. The effective collection of VAT on imports is significant for administration purposes. This point can be substantiated by the view that, “securing VAT collections on imports is generally a crucial part of ensuring effective collection of tax throughout the chain of production.”³⁵¹ This is particularly true in the case of a landlocked country like Lesotho, in the sense that it imports most taxable goods. Therefore, this would require effective administrative measures at the border posts as the first point where the goods are charged VAT.

³⁵¹ Ibid

5.9.2 Exports and Refunds in Lesotho

Table 20 - Question 11

Question 11: Has there been any effect of VAT on the level of exports? Has your level of exports declined or increased or have there been any other changes? If there has been a change, why do you think this has happened?

Responses: coded with numbers 1-5:

1- denotes answers that the businesses do not export but provide services and goods in the country – [65 responses]

2- relates to answers that there is no change on the level of their exports and the fact that exports are zero- rated is acknowledged as an advantage to exporters – [3 responses]

3- relates to answers that there is a change due to the process of clearing and checking the exports – [2 responses]

4- refers to answers that there is a decline of exports due to the process of refunds which is slow and forces exporters to keep their products for a longer time – [7 responses]

5- Denotes answers that acknowledge the advantage of exports being zero-rated as this enables their products to compete with products in the world market without bearing any tax in the country of origin – [2 responses]

The emerging view from the business entities on the treatment of exports and implementation of VAT is that the process of checking and clearing exports is slow. Similarly the issue of refunds has been one of the major concerns to exporters and the process was criticised for taking a long time. The slow process of clearing exports and making refunds can be a disadvantage to exporters in the sense, that some of them tend to rely on the tax being refunded to pay tax in the country where the goods are destined to be consumed.

It is the nature of VAT that some business entities will pay more tax on their inputs than is due on their outputs and ought to receive refunds. As mentioned already this is particularly true for exporters since their output is zero-rated under the destination principle and those whose investment purchases are large relative to their current sales (especially new enterprises).³⁵² An effective refund system is essential for the VAT administration and it is a crucial condition for VAT to be an efficient tax on consumption. Delay in VAT refunds could result in goods being diverted into the domestic market and is also likely to add a layer of “hidden costs” to registered firms and thereby discourage investment.³⁵³

In practice it appears that VAT refunds are delayed more in developing countries as compared to developed countries. It seems that the delay “derives from inefficient processing of refund claims and strong incentives for meeting revenue targets on the part of the tax administration.”³⁵⁴ This means that the tax administration prefers to hold on to the refunds and include them in their monthly collection to indicate that they have reached their revenue targets for the month. Therefore when the administration has reached its revenue target for the month, any amount of VAT received thereafter can be considered to pay refunds. Some countries allow for the excess of input tax over output tax to be carried over into the following tax periods. “For example, in Ghana, the excess tax credit - or the excess of input tax over output tax - is carried forward for three months, and after that, the refund will finally be made.”³⁵⁵

Furthermore there is a fear of abuse of the VAT refunds system on the part of the vendors, as VAT fraud is a common problem in all countries. For example, with respect to exporters it is possible that firms may produce false invoices or generate false exports for refunds.³⁵⁶ This puts more pressure on the administration to put in place an efficient monitoring and checking system when the refund claims are filed. The administration

³⁵² Ebrill, L., et.al., *The Modern VAT*, op.cit. p.155

³⁵³ Tuan Mihn Le, “Value Added Taxation: Mechanism, Design and Policy Issues” op.cit. p.43

³⁵⁴ Ibid

³⁵⁵ Ibid p.44

³⁵⁶ For a detailed discussion of the most common types of VAT fraud and issues in administering refunds see Brondolo, J., and Silvani, C., “Selected Issues in Administering the VAT: Cross-Checking Invoices and Controlling Refunds to Exporters (IMF: Washington D.C. 1996) as quoted in Tuan Mihn Le, op.cit. p.54

has to introduce ways of verifying the claims and also monitor the process of exports to ensure that all exports which are made are genuine. However, while the VAT system has to regulate the refund system to avoid abuse, on the other hand the administration should be mindful not to delay unnecessarily genuine claims for refunds from genuine vendors. This means that the administration should treat each application for refund on the basis of information which is available on the specific vendor.

The problems which underlie refunds have led countries to adopt tougher approaches in that respect, particularly developing countries. For example, it is provided that in most countries, “the legal and administrative framework is such that officials become reluctant to give tax refunds. Taxpayers often have to comply with tortuous procedures to obtain any kind of tax refund”.³⁵⁷ This tends to discourage investment on the side of export manufacturers. Furthermore, these procedures can affect trade and business activities within a country. This approach towards refunds in many developing countries has led to the view that, “the refund system is perceived as the major potential weakness of the VAT and main avenue of aversion; therefore, the authorities are reluctant to be too prompt on refunds, preferring to have time to inspect, in detail, large refund claims. This is a prudent requirement in any VAT system.”³⁵⁸ This approach and procedures of developing countries towards refunds is mainly to guard against false claims which are made by some business entities. Therefore, the administration tends to adopt detailed procedures which give them time to investigate each claim and also have time to scrutinize the tax history of each business entity that has lodged a refund claim.

The position in Lesotho with respect to refunds is highlighted in paragraph 4.9 as one area which remains a challenge to the VAT system. The system was criticised as slow by some of the business entities as indicated by the responses in Table 20 (point ‘**coded 4**’). There were 7 respondents that raised this issue and argued that from the exporters’ perspective this is discouraging and has affected the flow of exports. The number of respondents is high when compared to other responses and related to the

³⁵⁷ Casamegra de Jantscher, M. and Silvani, C., “Guidelines for Administering a VAT” in Tait, A.A. (ed) *Value Added Tax: Administrative Policy Issues*, op.cit. at p.36

³⁵⁸ Sanni, A., “VAT Refund System”, *CITN Tax Practice Series No.3* (Chartered Institute of Taxation of Nigeria, 2001) p.1 – quoted in “The Law and Practice of Value Added Tax in Nigeria” at p.270

number of business entities that answered the question. The delay in processing of refunds can result in a situation where exporters ultimately sell their products or offer services locally due to delayed refunds. Furthermore, where the refunds are delayed it can be a great disadvantage to the exporters, as their products are restricted from competing with similar products from other countries in the country to which they are exported. For this reason it can be recommended that refunds have to be dealt with by the administration within a reasonable time and in an efficient manner.

5.9.2.1 Conclusion

Delay in refunds can create serious problems for business entities in terms of adding a layer of “hidden costs” especially for export manufacturers which usually have a huge backlog of refunds but must still compete internationally. It is argued that this problem may ultimately discourage investment.³⁵⁹ In practice, it seems the VAT administration may wish to delay refunds in order to reflect them as part of their revenue collection for a month in order to present to the public that they do meet their revenue target without revealing the revenue that is paid as refunds.

The issue of refunds under the VAT system of Lesotho has to be approached with care in order to balance both the concerns of the business entities and the administration.

5.10 Tax Administration after VAT

Effective administration measures and strategies are crucial to the implementation of VAT. In this study business entities were involved to assess the administration of VAT and this is found to be very useful to get their views in that respect. This has also helped to establish how the administration of VAT is perceived by the business entities. This has also revealed the kind of relationship which exists between the administration and

³⁵⁹ Tuan Minh Le, “Value Added Taxation: Mechanism, Design, and Policy Issues”, op.cit. p.43

the business entities in the sense that, some views which were expressed tend to focus on how the business entities perceive tax administrators.

Table 21 - Question 12

Question 12: What has been the effect of the introduction of VAT at the points of imports, for example the border posts? Please give details of the level of service provided by the tax administrators.

The responses which emerged from this investigation are summarised in Table 22 and have been coded according to the type of answers which were given. 9 businesses did not respond to this question (it is impossible to ascertain the reasons for not doing so).

Table 22 - Responses to Question 12

Responses to Question 12:

(Answers grouped and coded in numbers 1-4)

1-relates to answers which tend to deal with the specific aspect of the level of service and supply an explanation – [10 responses]

2-denotes answers that the level of service is the same as before or there is no improvement or change [22 responses]

3-refers to answers which indicate that tax administrators are not very conversant with the new system and not confident about what they are expected to do. Due to this inefficiency on the side of the revenue officers, the border post system of dealing with VAT invoices and collection of VAT is very slow [25 responses]

4-relates to answers which think that the level of service has improved, average,

fair and slightly improved – (in some answers there is an explanation) – [13 responses]

Summary of the answers and how they were presented:

(1) Level of corruption and bribery has gone down since customs officials no longer handle cash at the border posts – most often the invoices which are submitted to the officials will indicate the amount of VAT paid in the country of export;

(1) Inspections at the border post are now quicker than under the previous system

(2) Same as before;

(2) There is no difference from the sales tax system;

(2) There is still no significant improvement on the level of service offered by the customs officials;

(3) Businesses are not well informed by LRA of any newly introduced border procedures;

(3) They do not have a clear experience of what they are doing therefore there is no significant change;

(3) There are delays due to the introduction of the new VAT system since both the customs officials and the taxpayers are not conversant with the system;

(3) Administrators were not sure what the correct procedures were and changes were implemented weekly – but now it has improved – with the new system where LRA claims VAT from SARS it is getting better;

(3) There were delays in the processing of documents – the level of service is poor - but gradually it is improving;

- (3) Tax administrators were not conversant with VAT – but it is improving;
- (3) Information which is given by officials at the head office was different from one given by the officials at the border post regarding for example the treatment of capital goods from South Africa;
- (3) No efficiency – waiting time is long and there is a lot of incorrect information captured by the officials;
- (3) There are delays due to the new system – people are not conversant with the system as yet;
- (3) Tax administrators are not conversant with VAT;
- (4) The service by the customs officials is fine, but the potential for importers to cheat at the border posts remains high –especially on products which have different VAT rates between Lesotho and South Africa;
- (4) There is an improvement in the service provided by the customs officials;
- (4) The import credit facility has made things easier – but the service by the customs officials could be better;
- (4) Average;
- (4) Fair;

There are two major views which emerge from the survey which were raised by the majority of the participants which are ‘**coded as 2**’ (22 responses) and ‘**coded as 3**’ (25 responses). These are; firstly, that the level of service which is given by tax administrators has not significantly changed (both at the border posts and the head office). Secondly, that the VAT officers give different advice on a single issue, which

tends to show that they are not fully conversant with the requirements and interpretation of the legal requirements.

Furthermore, it seemed that the customs officials at the border posts also treated issues relating to imports (and the documentation thereof) in a different way as compared to the VAT officials at the head office. The impact of getting two different opinions from revenue officers certainly tends to result in a lack of confidence in the revenue administration from the vendor. This is not the kind of result the administration hopes to achieve. This is an important administrative issue which has some consequences. Firstly, it can result in a clash between the central office, the customs office (at the border posts) and district offices. These local offices give different information to the business entities and sometimes the information which is given differs significantly from that which is given by VAT officers at the head office. This tends to undermine the authority of the officers at the head office and can result in a clash between different offices and affect the relationship between the offices. This can be worse, particularly where customs officers at the border posts give information which differs from one which is given at the head office. In this way, the business entities can doubt the credibility of the VAT head office staff in favour of the customs officers.

To achieve efficiency in the VAT system, there is need for support of the system by various government departments and the private sector. Therefore, the staff from the VAT office and the customs staff that are responsible for collection of VAT at the border controls should work to create good working relations and exchange information. This will enable them to consult each other where they are not sure with any aspect of the VAT requirements and obligations.

5.10.1 Conclusion

An effective and well organised administration structure is essential for an efficient VAT system. It is crucial to the VAT system that the administration staff is conversant with the legal regime and is able to interpret the requirements of the system to the business community. It is also important to maintain good relations between the tax

administrators and the business community for the efficiency of the VAT system. The business community tends to support and have confidence in a tax system if the administration is well established. It became apparent from this research that the business community would like to see the administration officers being readily available when they need to consult with them and to notify them from time to time of any newly introduced procedures.³⁶⁰ Therefore, this indicates that it is important for a tax system to establish effective communication mechanisms with the business entities in order to keep them informed of changes and amendments to the VAT laws.

5.11 How VAT is Viewed by the Business Community and their General Attitude to the VAT System

Table 23 - Question 13

Question 13: Please give your general views on VAT as a tax; effects of VAT on your business; effects of VAT on other businesses; effects of VAT on small businesses; and effects of VAT on those who intend to go into business.

The objective of this question was to find out the general views of the business community about VAT as a tax and their general attitude towards VAT, particularly its administration. Another important point was to find out the views of the business community on whether the implementation of VAT encourages or discourages business in general. The business entities have a direct relationship with the revenue authorities and from that perspective they are in the best position to comment on the general administration of VAT from their experience of dealing with the VAT officers and Customs officials.

The numbers of responses to this question overlaps in some cases. This is due to the fact that the question is general and the respondents elaborated their views which in some instances included more than one point. Some respondents raised more than one

³⁶⁰ This point emerged from the responses to Question 12 and is captured in Table 22 as points which are coded ‘3’ and ‘4’

theme in their response and that affects the numbers of responses which tend to add up to a high number of participants and exceed the actual number of participants. As a result the number of responses has not been allocated to each theme on the understanding that this might differ from the actual numbers of respondents.

Table 24 - Responses to question 13

Answers from this question have been grouped into 9 different themes.

(1) There has been an increase on prices as a result of the 4 per cent difference between the 10 per cent (standard rate) under sales tax and the 14 per cent (standard rate) under VAT.

(2) Advantage of being able to claim input tax where it is applicable, so that it no longer becomes a business expense (this is an advantage for those who are intending to go into business) – VAT is shifted to the consumers and the businesses merely collect the tax on behalf of the government.

(3) VAT gives some kind of cash flow advantage to the businesses since they have to keep the money in their accounts for a period of one month and can only pay the VAT due within 20 days after the end of the tax period – in the same way the firms tend not to create separate bank accounts for VAT to be handed over to the government while they have not yet paid it.

(4) Concerns with competitors who are not charging VAT; lack of competition through either some businesses being below the threshold; or registered businesses bargaining with a customer and offering a lower price if the customer does not require a tax invoice; the costs of collecting VAT; a belief that everyone takes every opportunity to reduce their VAT obligation; and an unfair burden carried by small businesses.

(5) Some businesses were concerned about the fact that there was bribery which was going on at the border posts – involving some businesses and customs officials – this

involved smuggling of goods which are zero rated in South Africa but are chargeable to VAT in Lesotho. This discourages some business entities since their competitors have an advantage over them in that way – they then sell similar products at a lower price since they did not pay VAT. This point was raised by a number of businesses in retailing and wholesaling.

(6) VAT as a tax is easier to administer and easy to trace through its invoice credit method which is used in Lesotho. The business entities acknowledged the fact that VAT through its invoice credit method offers more advantages in terms of administration efficiency of the tax.

(7) VAT is more efficient in terms of revenue collection by the government as it can be easily monitored and enforced. This derives from the feature of a VAT as a multi-stage tax and the fact that it is collected at every stage of production reduces the risk of avoidance and fraud in the sense that tax which is not included at an earlier stage can be collected in the next stage. Therefore, this means that the government is guaranteed some revenue in the process.

(8) VAT refund gives negative impact to the cash flow – favours sales tax over VAT. The argument on this point is that the refund which has to be paid to the business entities tends to have a negative impact on the cash flow particularly where the payment of refunds is delayed by the administration.

(9) There were concerns that businesses were having problems with securing regular payments from the government departments which they served, since government uses the system of ‘orders’ and ‘invoices’ and payments are made after a long time - in some instances a year – the business entities considered this as a disadvantage since they cannot include that in their returns and claim a refund promptly.

The responses are discussed in more details with reference to existing principles of VAT below and other issues which are related to the system are also highlighted. The sequence of discussion follows from the presentation of the responses in Table 24. However, the first identified theme (theme 1) of the responses overlaps with responses to Question 8 which deals with the effect of VAT on prices and it is not discussed any further in this part in order to avoid repetition. Theme 3 and 8 are merged as they raise a similar issue. Similarly, theme 7 is not discussed further in this part since it deals with an issue of revenue efficiency of VAT. This issue can only be supported by information from the administration as the business community could not provide any proof of the efficiency of VAT towards revenue collection.

Theme 2 deals with the nature of VAT. Under this theme, the business entities recognise the fact that registered vendors are able to claim input tax which has been incurred and this demonstrates some knowledge and understanding of the nature of VAT. This means VAT does not become the burden of the trader. However, the trader should be able to produce supporting invoices and this is checked against the invoices issued to the seller. The burden of VAT in actual fact falls on the consumers and unregistered traders, but not the registered vendor who pays the tax to the revenue authorities. Though VAT has a mechanism where business entities can claim their input tax, this does not extend to the last stage of production where the consumer or an unregistered business entity is involved. Therefore, this can encourage people to go into business since registered business entities are allowed to recover tax which is paid earlier (input tax). On the other hand, other legal obligations such as compliance costs and completing VAT returns also have to be considered against this point.

Theme 3 and Theme 8 deal with responses which concern the cash flow problem which the majority of business entities seemed to experience. It appears that the majority of businesses tend to treat the VAT money collected in the same way that they treat their business cash. They deposit the money in the business accounts and in the process divert it into a form of security to secure a loan from the banks or on the other hand to earn interest from the bank. The business entities should be able to maintain at least a mental accounting distinction of separating VAT monies from business turnover

and the relationship with other key concepts.³⁶¹ This need not only have to be a mental accounting but the businesses should be encouraged by the inspectors to keep separate bank accounts for VAT monies. This will help them not to divert the VAT monies to their own business expenditure.

On the other hand, it can be argued that the business entities are having an advantage in keeping VAT which they collect, in the sense that they keep the money which belongs to the government, without having to account for any interest earned during that period. This is an advantage to the business entities as they earn interest from the money while it is at the bank before the end of the tax period (or they can use it to reduce their borrowings). Therefore in that sense, the business entities do benefit from the tax.

Theme 4 deals with competition and evasion of VAT – Some of the responses revealed that the business entities were concerned about the fact that some registered vendors were not charging VAT and yet they were required to do so. It was revealed that these vendors absorbed the tax in their business costs and this resulted in consumers and other unregistered traders buying or acquiring taxable goods and services at a lower price from the concerned traders. This means that these vendors had an advantage over other business entities as they attracted more consumers. My interpretation of this concern is that this raises a question of competition amongst the business entities. Moreover, it should be the concern of the revenue administration rather than other traders. Another point which comes up under this theme is that the small businesses who were not registered gained an advantage over the registered traders, as they did not bear any compliance costs. A counter argument towards this is that some business entities fail to understand how VAT works and how it is implemented.

Theme 5 concerns the administration of imposing and collecting VAT at the border posts and the problem of smuggling. It appeared that the business entities were concerned about the administration of VAT, particularly at the border posts. They argued that the administration failed to charge VAT on some of the goods which are

³⁶¹ Adams, C. and Webley, P., "Small business owners' attitude on VAT compliance in the UK" *Journal of Economic Psychology* Vol.22, April 2001 Issue 2, pps.195-216 at p.15

chargeable to tax which were zero-rated, for example in South Africa, or were not charged VAT in the country where they were exported. They complained of the level of smuggling of goods and the involvement of revenue officers at the border posts. It appeared that some officers were involved in smuggling of goods from South Africa into Lesotho and their failure to impose VAT on the imported goods by some business entities accordingly also raised concerns and suspicion to other importers. Other business entities complained about this practice and argued that it resulted in unfair treatment to themselves.

Theme 6 raises issues which relate to the advantages of an invoice credit method of VAT. The majority view was that it is easier to deal with and they held the view that it is easy to administer. The invoice credit method is easy to trace through the invoices which have to pass from the supplier to the buyer and in that way, it is easy for the administration to trace the VAT which has been paid. It is also easy to verify transactions which involve taxable supplies and those which do not. It is easy to trace the transactions and reduce any fraud. The business entities highlighted the importance of these advantages as contributing to the credibility of the VAT system.

Theme 7 deals with the efficiency of VAT in respect of revenue collection³⁶², while theme 8 is discussed with theme 3 as they both deal with the issue of cash flow.

Theme 9 raises problems which are caused by the delay of the government in making payments to its suppliers and issuing invoices where they make taxable supplies of goods or services. It appears that this is a disadvantage to the business entities, as they cannot include such supplies in their tax returns for the period when they were undertaken and pay the tax accordingly to the revenue authorities. This also means the business entity cannot claim any input tax which relates to such supplies (during the tax period concerned) as long as payment and the invoice has not been made available. It seems this really is not a direct issue which results from the VAT system although the VAT system has emphasised its effects. It concerns the way the government departments

³⁶² Though this point was raised by some business entities, the point could not be substantiated by the business entities as it is an administrative issue and can only be substantiated by the revenue collection reports. This has been discussed in chapters 2 and 4.

operate in terms of making payments for their supplies to the suppliers. This does have some consequence when business entities (suppliers to the government) have to complete their tax returns at the end of a tax period, since they cannot include such supplies as payments including tax have not been made at the time. This creates a problem particularly where the business entities wish to claim a refund from the administration.

5.11.1 Conclusion on How VAT is Viewed by the Business Community

In a more general way the comments which are made with respect to whether VAT is a good tax or not, tends to bring out two different views. Some business entities thought VAT as a tax is good and more advantageous than sales tax, and others viewed it as fair. This view gets support from the fact that all registered business entities are treated equally; they receive similar advantages; and have similar obligations. The position was different under the sales tax system. Under the sales tax system even if business entities were registered they were not automatically entitled to an 'exemption certificate', as this was granted solely on the discretion of the Commissioner. Furthermore some business entities held the view that VAT has contributed to an improved and relatively effective administration, which is beneficial not only to the collection of VAT but also to the benefit of other taxes, such as Income taxes and Customs and Excise tax, and even to the businesses themselves.

On the other hand a dominant view seems to be the concern with the administration system of VAT. Though the structure and design of the tax are acknowledged for various advantages, the major concern is the administration aspect of the tax. This is a vital aspect in implementing the tax, therefore, a stricter administration regime is recommended to ensure that issues of smuggling, cheating and avoidance are eliminated or significantly reduced and so that they are not perceived as a problem by honest traders. Furthermore, improved administrative measures and approach will result in improved attitude of the business entities towards the administration.

5.12 Conclusion

This chapter focused on issues which are relevant to the practical implementation and administration of VAT in Lesotho. The issues which are examined are critical to the efficiency of the VAT system. The discussions in the chapter are based on the survey and the questions which were developed for that purpose. The findings of the survey form an important part of analysing the VAT system in Lesotho.

The results of the survey reveal that a proportion of registered vendors holds the view that administration of VAT is problematic and needs to be improved with the aim to ensure efficiency of the tax system. Furthermore, the dominant views on the efficiency of VAT as a tax are that it is complicated; expensive to comply with; and badly administered in Lesotho. In the analysis of the administration and implementation of the VAT system in Lesotho, a number of significant themes have emerged. These themes are grouped into two parts: - firstly, themes which are identified as challenges to the VAT system in Lesotho; and secondly, themes identified as positive issues towards the system.

5.12.1 Positive Issues towards the system

- VAT is a good tax and is easier to administer from the business perspective;
- The introduction of VAT in Lesotho is important for aligning the tax with VAT which is in place in South Africa. The treatment of goods and services in the two countries are more or less the same, therefore there is less paper work for the business entities (at the border posts) as the standard rate of VAT is the same and there are fewer queues on both sides of the borders;

5.12.2 Challenges

- Administration of VAT by LRA needs to be improved, information given by VAT headquarters is confusing and advice given is not consistent. Administrators lacked knowledge on VAT legislation, but it is improving - tax administrators still have to learn and understand the VAT legislation and how it works and what their role is;
- VAT is discouraging to those who want to go into business since VAT is expensive to the business community;
- Control problems at the borders make the system complicated and it is still open to abuse by other traders, bribery and smuggling of goods from South Africa into Lesotho, mainly where the goods enjoy zero-rating in South Africa but are taxable in Lesotho. Border controls both on the Lesotho and South African side pose a problem. Accusations of some elements of corruption of border officials have come up from a significant number of the business entities. This needs to be closely monitored and improved as it works as a disadvantage to other business entities. Another related issue is one of cheating which appears to take place at the border posts by some business entities. This issue seems to have come in different questions and therefore is a significant issue which undermines the administrative framework;
- The issue of administration of refunds to exporters and other categories of entities remains a challenge to the administration.

**PART III: THE ADMINISTRATION OF VAT AND CROSS-BORDER
TRANSACTIONS**

Chapter 6: Issues of Cross-Border Trade and VAT: The Administration of Cross-Border Transactions

6.1 Introduction

This chapter examines particular issues which arise from cross-border trade transactions and their impact on the implementation of VAT. These are examined in the context of inter-jurisdictional principles which are relevant to taxation in cross border situations. These principles are based on two theories; the Origin theory and the Destination theory which govern taxation of goods and services in cross-border situations.

This part of the thesis focuses on the relevance of the inter-jurisdictional principles of taxation to administration of VAT in a cross-border situation where a small country such as Lesotho is landlocked within a bigger country (both economically and politically) like South Africa. The questions which arise are: - what issues are likely to arise and have an impact on cross-border trade transactions under such situations? What are the likely problems and opportunities which can arise where there are cross border transactions in such cases?

The position in Lesotho in regard to cross-border trade is likely to be constrained by the fact that the vast majority of cross-border trade transactions arise only between Lesotho and South Africa (a small proportion of cross-border transactions take place with the other SACU member states). Lesotho relies on South Africa for the majority of its imports and this raises challenging issues for the administration in the implementation of VAT. The relevant cross-border taxation principles are relevant in charging VAT on imports from South Africa when they enter the Lesotho borders.

6.2 Destination and Origin Theories: An Overview

The rules which govern taxation of goods in cross-border trade in theory are influenced by a number of factors: - The first issue that arises in cross-border cases is to decide which country's tax rate determines the final tax burden and which country has the right to tax the goods. For example, where the goods are produced (or created) or where value was added in one country (A); and are sold in another country (B) (this means the seller and the buyer are located in different jurisdictions). The question is which of these two countries has the right to charge VAT on the goods? Should it be the country of production or where value was added (A) or should it be the country where the goods are consumed or where the buyer is located (B)? This is a question of jurisdiction which determines which country's tax rate applies. The question also has consequences for the total revenue collected on VAT.

A number of options are available as to how to deal with the issue.

- The first option is to tax the goods in both countries, this means state A charges tax if it has an origin-based VAT, and state B will also charge tax if it has a destination-based VAT.³⁶³ This results in double taxation and the disadvantage of double taxation is that it deters international trade.
- The second option is not to tax the goods at all in any of the two countries. The disadvantage of an absence of taxation in this situation results in discriminatory treatment between imported goods and domestically produced goods. Under such circumstances the imported goods are given an advantage over domestic products, which are taxed since the tax from such products has to be passed on to the consumer. This is likely to result in a higher price than the goods which are imported since they do not include any VAT. Practically it means that double taxation can only be removed if the two states have the same taxation system, either the origin system or destination system.³⁶⁴

³⁶³ Williams, D., "Value-Added Tax" op.cit. p.171

³⁶⁴ Ibid

- The third option is to tax the goods in either country A or country B, that is either in the country of origin (production or where value was added) or country of destination (consumption). This is determined by which of the two principles of cross border taxation each country has adopted. This option appears to be a more favourable one. In practice, most states that impose a VAT on imports exempt exports from the charge to tax. Similarly, this would mean that states should exempt imports where exports are taxed. The method would depend on the system which each state has adopted.

The second issue which comes up is which country benefits from the revenue? This follows from the issue of which tax rate determines the final tax burden on goods and services in cross-border transactions. This is important in establishing to which country the revenue accrues to. This can be the country of origin; or where value was added or the country of consumption. This is determined by the taxation system which is adopted in the given country. *new*

The third issue which comes up in cross-border cases is an administrative question that is, which of the two countries has the right to collect the revenue? Would it be the country where value was added or where the goods originate; or where the goods are consumed? This is an important point as it is relevant for purposes of administration and collection of VAT. This issue also affects the level of revenue which is collected on imports and exports in each country (depending on which taxation system is in place). *new*

In dealing with the above questions and controversies in cross-border issues the following two principles can be applied: - The first principle is based on the origin theory. According to the origin theory all the VAT liabilities are determined by the country of origin. This means that everything that is produced or created (and where value is added) domestically is taxed and when the goods are exported they bear the VAT of that country. (This can be where the supplier is established.) Under this theory, the country of production or the country where value was added has the right to charge VAT. It also means the revenue accrues to the country of origin (or where value was added). ✓

The second principle is based on the destination theory. According to this theory the VAT liability arises in the country where the goods are consumed or where final purchase takes place. In effect, destination principle can mean one or more of the following three things: - (a) that tax is collected by the country where the goods are consumed; (b) that tax is charged at the rate of the country where the goods are consumed; and (c) that tax is allocated or goes to the country of consumption. The destination principle therefore subjects the total value of goods to the tax of the country of consumption in the sense that tax is either collected or charged or allocated to the country where the goods are consumed. Under the destination theory, exports are tax free and VAT is imposed on all imports. The destination system requires border controls, in order for the customs officers to check the tax status of the goods which are being imported and those which are being exported.

In practice, there is no international agreement which regulate these kinds of issues. Therefore, it all depends on which principle of taxation each country decides to adopt. It appears that the majority of countries have adopted the destination principle as the basis of taxation of cross-border trade transactions. In practice states tend to use one of the principles, except in the EU where the transitional system classifies transactions and either taxes them under the origin principle or the destination principle.

Furthermore, in practice states have made a distinction between imports of goods and imports of services. This distinction lies in the fact that when goods are imported into a country they can be physically identified, whereas this is not so readily the case with services. It is not possible to identify services physically. States have adopted rules to define how services are supplied and that determines whether the supply is within the state or outside the state. It is acknowledged that with the latest technological developments in relation to some goods, they no longer have to be delivered physically through border posts. For example, music or movies can be downloaded from the internet rather than involve the physical delivery of CDs or DVDs. These issues can be regulated by the rules which relate to VAT and Electronic Commerce, which subject is outside the scope of the present study.

6.3 Issues Arising from Cross-Border Trade Transactions and the Implementation of VAT in Lesotho

There are various issues which arise from cross-border trade transactions which have an impact on the implementation and administration of VAT in Lesotho. These concern the VAT treatment of imported goods and exported products at the border controls and the administration measures which are in place to charge and collect VAT accordingly. The administration of VAT at the border controls is significant in Lesotho in the sense that VAT which is collected from imports tends to be one of the main sources of VAT revenue.

The first point which is raised by cross-border trade is the issue of smuggling of goods. This is significant where neighbouring countries or the country of the seller and the buyer do not have the same VAT rates. For example, in the case of Lesotho and South Africa, there is a difference of rates on items which are zero rated in South Africa and which are taxable in Lesotho. This means when these items are imported into Lesotho, they are chargeable at the applicable VAT rate in that country. Smuggling of goods can occur where customs officers fail to carry out their duties effectively. For example if they do not check the imported goods, this gives an opportunity to the business entities and private individuals to smuggle goods. The point came up in Lesotho and it appears that customs officials may be involved or complicit in the smuggling which takes place.³⁶⁵

Apart from smuggling of goods through the official border posts there is likelihood to smuggle goods through other means. The border boundaries between Lesotho and South Africa are in most cases represented by a river and where that is not the case, the boundary is demarcated by a fence. In some cases the towns near the borders both on the side of Lesotho and South Africa are nearer to the border posts and are within walking distance. Therefore, there is a chance to smuggle some items through the unofficial crossings as it is the case with people who cross through these areas if they do not have valid official travelling documents or visas to cross into either Lesotho or

South Africa. On the other hand, it is acknowledged that the smuggling of this nature is more likely to be carried out by individual customers and importers with smaller items rather than business entities.

The second point which is a major part of cross-border transactions between Lesotho and South Africa concerns cross-border shopping. Cross-border shopping again results from the different rates of VAT between neighbouring countries or between countries which are members of an economic grouping. In such cases, there is a potential for business entities and consumers to purchase their goods from a country which has low tax rates. This means for example that if countries in an economic grouping tax transactions within the member states under the origin principle, all the tax which is chargeable accrues to the country where the goods are produced or purchased.

The relevant point is what is the impact of cross-border shopping on the level of revenue and the tax system of a country which has higher rates than in other countries? What would be the effect of cross-border shopping on the economy of a country which has higher rates where the majority of its business entities engage in cross-border shopping in countries with lower rates? It can be argued that the level of cross-border shopping should be very high, so as to have a tremendous impact on the level of revenue of a country.

As far as Lesotho is concerned, there has not yet been any research which has been carried in relation to the issue of cross-border shopping and its impact on revenue. However, with the level of cross-border shopping which takes place between Lesotho and South Africa, which is mainly one sided (mainly consumers and traders from Lesotho cross into South Africa to shop) it can be presumed that the issue is significant particularly to the Lesotho government. In the case of these two countries, the cross-border shopping does not necessarily result from the difference in tax rates since the VAT standard rate in the two countries is 15 per cent. This means that there are other causes to the cross-border shopping which are not tax related.³⁶⁶

³⁶⁵ See Table 24, paragraph 5.11

³⁶⁶ For example, this could be attributed to the wider selection of products and easier access to a wide range of shops

Another significant point which is relevant to cross-border shopping which occurs between Lesotho and South Africa is that the majority of cross-border shopping occurs from people in Lesotho who live near the towns which are near the borders with South Africa. This results in individual shoppers and business entities from Lesotho purchasing food products and other household items from the neighbouring South African towns. Though in this particular case, there has not been any official study carried out on cross-border shopping and its impact on VAT, the views expressed are purely based on personal observations. One has observed in practice that items such as petrol and paraffin are cheaper in Lesotho than in South Africa, therefore, they would not be part of items purchased in South Africa. (A study on this area of tax law could prove to be vital to Lesotho in future).

The third point is to examine the significance of border controls in the implementation of VAT on cross-border trade transactions. The issue is; what is the role of border controls in cross-border trade transactions and in imposing VAT on either imported or exported products? The advantage of border controls is that it is easier and more effective to inspect the products imported and the documents (and invoices) at the time they enter the country. This also allows for VAT to be imposed immediately on goods which have not been taxed from their place of production or origin. This method of imposing VAT on imported items can be very effective in securing substantial revenue from imports. In the same way, border controls are important in relation to exports, as customs officers ensure that exports actually leave the country and where appropriate, tax is collected; or alternatively, to ensure that they leave the country tax-free and are not diverted into the domestic market. Therefore, it is submitted that the existence of border controls is more effective to reduce the problem of smuggling of goods across the borders in the sense that there is the opportunity to carry out physical checks on cars and goods themselves.

Border controls are an effective way for the government to exercise its political control to regulate the movement of incoming and outgoing goods within a country. It can be argued that where the border posts are effectively administered and the necessary resources are available (for example, sufficient number of skilled and trained customs

officers; and customs declaration forms are available with clear instructions), they are an efficient means to charge VAT (and customs duties) as well as clearance of exports.

The principles on border controls are relevant to the implementation of VAT in Lesotho in the sense that both Lesotho and South Africa maintain their border controls and tax frontiers. This is the position amongst all states within SACU. The importance of the existence of border posts in implementing VAT is that the right of each country to impose VAT is confined only within its jurisdiction (borders). This means that they tax goods when they are imported into their jurisdiction (as countries of consumption) and exports leave their jurisdictions tax free.

There are disadvantages associated with the use of border controls for monitoring the import and export of goods. The existence of border controls and border checks may hinder the political desire to achieve complete integration and free movement of goods within an economic community and customs union. In this sense, the concept of integration within a customs union or common market is equated to free movement of goods and persons within member countries.

The other disadvantage relates to high costs for maintaining the border controls. The costs are associated with the need to have customs staff at the points of entry at all times when the border controls are operating. Furthermore, the other disadvantage of border controls relates to the time the customs officers spend examining the imported items. It can be argued that it is time consuming both on the administrative side and on the side of the business entities to check the goods physically and invoices at the border controls. This may also deter interstate trade because of rising transportation costs and waiting time associated with such checkpoints.³⁶⁷ This can result in long queues and delays to the business entities particularly where the administration is not very effective and does not have sufficient customs staff to undertake the task. In relating this point to the implementation of VAT in Lesotho, it is important to point out that lack of efficient administration measures at the border controls can actually have an impact generally on business as it is indicated by responses which are **'coded 3'** in Table 22.

³⁶⁷ Oliveira, J.E.S., "Economic Effects of Origin and Destination Principle for Value-Added Taxes" George Washington University 2001 paragraph. 4:5:1

On the other hand, there are disadvantages towards the abolition of border controls and fiscal frontiers. The abolition of border controls is likely to result in an increase in the cross border shopping by individuals who are likely to cross over to the neighbouring countries with lower tax rates than their own country. This means that countries with lower tax rates will benefit more from the revenue which is collected than the other countries where the individual consumers are resident.

This issue can also be discussed in reference to the position in the case of Lesotho and South Africa. The practice of cross border shopping between Lesotho and South Africa has always existed prior to the introduction of VAT in Lesotho. This is the result of the fact that Lesotho is a small, underdeveloped country and economically relies on South Africa economically. Prior to the introduction of VAT in Lesotho, the sales tax was applied at a lower rate than the VAT (standard rate) in South Africa. In that respect, the expectation would be that cross border shopping would decline to an extent. However, though there is no specific statistics or official report which can be referred to, on the basis of my own observations, the fact that the sales tax rate was lower than the VAT rate in South Africa did not have any impact on the level of cross border shopping since the level of shopping did not go down.

The other disadvantage for abolition of border controls, relates to the issue of revenue which accrues from VAT. Under destination taxation revenue accrues only to one country, which is the country of consumption. Therefore, where border controls are abolished, the concerned countries have to cooperate and establish a mechanism of how to collect and charge VAT.

The other significant point which underlies cross-border transactions in Lesotho and South Africa relates to the issue of companies which operate across the two countries. There is a substantial number of subsidiary companies operating in Lesotho whose parent companies are South African companies and are based there. In practice it seems the problem is that these subsidiary companies buy goods from their own parent companies and they under-invoice these goods which are exported to Lesotho to ensure that the subsidiary companies do not pay a high import VAT in Lesotho. Conversely rather than under- invoicing they can overstate the prices for purposes of claiming a high

but if we
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matter

input tax credit. On the other hand, it is possible that these subsidiary companies can conceal their sales/turnover by keeping two separate records in order to avoid registering for VAT in Lesotho and escaping the obligations that arise from the legislation. In practice they can keep separate records for the VAT inspectors which are different from the records and invoices which have to be submitted to the parent company in South Africa.

6.3.1 Supply of Cross-Border Goods and VAT in Lesotho: Administrative Arrangements for charging VAT on Cross-border Transactions in Lesotho

The administration of VAT at the border posts in Lesotho is the responsibility of Customs division. This means they have to charge and collect VAT on imports at the border posts and other ports of entries in Lesotho.

VAT is collected from importers³⁶⁸ under two situations; - first, those who fail to produce tax invoices to show that VAT has already been paid on the imported goods; and secondly, where the imported goods were not chargeable to VAT in the country where they were purchased, but are chargeable to VAT in Lesotho. This can also be the case where the seller fails to charge any VAT on the goods. In the case of Lesotho imports can be brought in from South Africa (which is the immediate and only country neighbouring Lesotho), ^{and what?} other SACU countries and from countries outside SACU. Though most goods which are imported into Lesotho are from South Africa, some registered business entities, particularly retailers buy from local suppliers. There are few of these entities which also import from Zimbabwe, Botswana and other countries outside the SACU area. As previously mentioned, there is a lot of cross-border shopping which is taking place between Lesotho and South Africa. It is one sided, that is more business entities and consumers from Lesotho cross into South Africa for daily shopping and for importation of business goods. This is partly a result of different VAT rates in

relation to certain goods which are zero-rated in South Africa but are chargeable to tax in Lesotho.

It seems that the administration makes a distinction between tax collected on imports from SACU and imports from other countries in terms of classification. VAT which is collected on imports from SACU countries is referred to as 'Import VAT'.³⁶⁹ This is supported by the fact that there is another category of VAT which is classified as 'VAT from the border posts',³⁷⁰ and it can be understood to refer to VAT collected on imports from countries other than SACU countries. I think the significance of this distinction is for purposes of classifying revenue which accrues thereof accordingly. VAT is collected on all cross-border goods at the border posts or other points of entry into Lesotho, whether they originate from SACU countries or elsewhere.

The significant point which underlies the administration of VAT on Cross-border transactions relates to the provision of special regulations which deal with imports from South Africa. This is a direct consequence of the geographical situation of Lesotho as a landlocked country within South Africa. This has resulted in various arrangements and agreements being made to regulate the movement of people and goods between the two countries.³⁷¹ It is important to note that Lesotho and South Africa have not adopted any common VAT system to regulate their cross-border transactions. However, the two countries have concluded an agreement which regulates the administration of VAT on cross-border transactions since 2003 when VAT was introduced in Lesotho. This agreement regulates the process in which VAT which is paid by consumers and business entities from Lesotho in South Africa can be refunded to the Lesotho revenue authorities (on the basis of a tax invoice) rather than being refunded to the consumers and business entities at the time they export the goods from South Africa. As a result, a limit has been

³⁶⁸ In terms of Section 3 of the Lesotho VAT Act, "importer" means – (a) in relation to an import of goods, any person who owns, possesses, or has a beneficial interest in the goods at the time of the import; and (b) in relation to an import of services, the person to whom the services are provided

³⁶⁹ See paragraph 4.8.3

³⁷⁰ VAT Division Report, July 2005

³⁷¹ For example, the two countries have some kind of arrangement for movement of people between the two countries who can show that they make regular business visits or do shopping either way to be granted a 6 months' permit which allows them to cross into each country without having to be subjected to

imposed on the level of imports into Lesotho from South Africa, which are not restricted and where VAT is not chargeable upon importation at the border posts in Lesotho.

In view of that, the VAT regulations do allow importation of goods up to a specific value from South Africa into Lesotho without payment of any VAT where VAT was imposed on the goods by South Africa and not rebated on export. In terms of regulation 19³⁷² the total value of the imported goods by an individual for any one day should not exceed M250 (Two Hundred and Fifty Maloti). This means that the customs officials have to check the invoice of the goods and verify that the value of such goods is below M250 to allow the importation of the goods without charging VAT.

VAT is payable at the Lesotho border posts in respect of any goods purchased over the value of M250 under the following circumstances: -

- Where the South African tax invoice is unacceptable - For a South African Tax Invoice to be acceptable it must bear the following elements: ³⁷³ a VAT registration number (a 10 digit number); an invoice number, an invoice date; and the VAT amount paid or an indication that VAT at the standard rate is included. In cases where the invoice is not authentic, the authorities have refused to accept it. (It appears that some of the invoices have gone unpaid by SARS because they were unacceptable and in some cases the VAT registration numbers on the invoices are not valid or genuine, therefore in such cases SARS does not accept and refund them.³⁷⁴)
- Where imports relate to goods which are zero-rated in South Africa but are subject to VAT in Lesotho. These include cooking oil, fruits, rice, and fresh vegetables.

The customs officers are expected to check each tax invoice when it is produced before the goods can be imported into Lesotho. In cases where the VAT on imported goods from South Africa is of a higher value than M250, the importer has to hand the

customs control all the time. Though the permit is restricted in most cases to crossing between 6.00 am and 8.00pm, in practice people are permitted to cross at all times.

³⁷² *Value Added Regulations 2003*, Lesotho Government Gazette Extraordinary 27th June 2003 No.53

³⁷³ LRA VAT Refund Form

³⁷⁴ Interview with the Principal Collector, Return Processing Unit

invoices to the customs officials at the border posts, so that the buyer does not have to pay VAT in Lesotho. The invoice forms the basis for LRA to claim refunds from SARS. SARS remits VAT to LRA (VAT division), which has been paid by importers (both consumers and business entities) from Lesotho on the supply of goods (and services) in South Africa where the goods are subsequently removed from South Africa.

Furthermore, for VAT invoices to be acceptable and paid by SARS they should have been authenticated by SARS officials (on the South African side of the border) after they have inspected the goods to ensure that they do leave the South African jurisdiction. They subsequently attach their stamp to the invoice before it can be submitted to the LRA officers at the Lesotho border posts. These invoices are compiled and transmitted to SARS (by LRA officials) to claim the VAT which should in actual fact have been refunded to the importers who imported goods from South Africa. This means that rather than the importers having to pay VAT in cash to the Lesotho customs officers, their invoices are taken as proof of VAT paid in South Africa which LRA can claim from SARS.

The advantage of this arrangement is that it ensures that all imported goods which are chargeable to VAT are appropriately taxed in the sense, that if there is no proof for paying VAT in South Africa, the importer (into Lesotho) has to pay tax at the border post. Therefore, this guarantees revenue to the Lesotho government. Furthermore, this has shifted the burden to claim refunds from the business entities or consumers to LRA and therefore, LRA is the one which has to deal with all the paperwork, rather than the consumer or the business entity.

The importance of this arrangement between LRA and SARS is also seen particularly in respect of VAT which is charged on motor vehicles imported into Lesotho. There are two situations of imposing and collecting VAT on motor vehicles. These are in relation to the importation of new motor vehicles; and used motor vehicles or 'second hand' motor vehicles as they are commonly known in Lesotho.

The rules on how VAT is charged on new motor vehicles focus on vehicles which are purchased from countries within SACU member states (particularly from South Africa). Where a motor vehicle is brought into Lesotho, the importer has to

produce a tax invoice to Customs officers at the border posts. The invoice should show that VAT has been paid to the seller in the country where the motor vehicle was purchased. The importer is subsequently referred to the VAT office where the importer is issued with a clearance certificate and registration certificate for the motor vehicle. In a situation where the importer has not paid VAT to the seller, the importer is therefore required to pay VAT upon importation of such a vehicle. The importer has two choices, either to pay the tax at the border post or alternatively, he must produce the invoices (and other documents) to the Customs officers. The importer is then issued with an appropriate form for VAT to be paid at the VAT office. This area of control by the customs officials is directly related to the collection of VAT. Even though in certain cases, the customs officials (at the border posts) do not collect VAT, they have the duty to check invoices and to refer the importer to the VAT office to pay VAT accordingly. This is a crucial area of administration of VAT, as it depends on the effective communication and exchange of information from officials at the border posts to the revenue officials at the VAT head office.

The position in regard to used (second hand) motor vehicles is that in April, 2004 LRA introduced a new regulation which allows importers who purchased used motor vehicles in South Africa from registered persons (registered for VAT in South Africa) to bring the vehicles into Lesotho without paying VAT in Lesotho. These arrangements require the importer to submit VAT invoices to the customs officials at the border post and LRA claims the VAT directly from SARS.

As a result of the proximity of South Africa to Lesotho and the geographical situation of Lesotho, it is common practice for Lesotho residents to buy used vehicles in South Africa. Upon importation of the vehicles into Lesotho the importers decide not to pay any VAT (as previously with sales tax) but to leave the vehicles with the car registration numbers from South Africa. (This means the motor vehicle crosses the border disguised in order to avoid payment of VAT). These VAT rules which were introduced in 2004 extend to these kinds of motor vehicles which have not been charged to VAT when they were brought into Lesotho. LRA has an interest to see that people

register their motor vehicles in Lesotho since they are obliged to pay VAT before they can be registered.

It seems these administrative arrangements between LRA and SARS rely on the cooperation between the two administrative bodies. This cooperation is important particularly in handling the invoices and exchanging any information which is relevant thereto.

6.3.2 How the Origin and Destination Principles applies to Cross-Border transactions between Lesotho and South Africa: Which is the best principle?

The present administrative arrangements between Lesotho and South Africa on charging, allocating and payment of VAT on cross border transactions mean that the transaction is charged VAT at the rate of the origin country (South Africa) but the revenue is eventually allocated to the country of destination (Lesotho). The tax rate which is charged on the transaction is the VAT rate in South Africa and the tax is also collected by South Africa. Lesotho has to claim the tax (from South Africa) on the basis of invoices submitted by importers of goods into Lesotho. Therefore, this means that the tax is eventually allocated to Lesotho in terms of the destination principle based on existing administrative arrangements between LRA and SARS. In this sense it can be argued that the VAT system in Lesotho (and South Africa) on cross-border transactions is origin in structure, but destination in the sense of eventual allocation of the tax.

The advantage of these administrative arrangements is that since VAT is claimed directly from SARS by LRA, this releases the importer from paying VAT in cash upon importation in Lesotho – the actual payment of tax is suspended and dealt with administratively by the two revenue authorities. Another advantage of the arrangements is that since there are only two countries involved, the manner and method of allocation on the basis of the destination principle has been easy and to an extent effective. The effectiveness of the destination principle lies on cooperation between the revenue

authorities in handling and verifying the invoices and eventually allocating the tax to LRA.

In this sense, it can be submitted that the Lesotho – South Africa administrative arrangements on charging VAT on cross-border transactions is a mixture of both the origin and destination taxation. It seems that the present system of charging and collecting VAT on cross-border transactions is the best principle in practice. The fact that the two countries, Lesotho and South Africa still maintain their border posts, this system has reduced an amount of paper work which would be involved if the importers were to claim the refunds at the South African border and have to pay VAT at the Lesotho border posts. This has also addressed issues of delay in processing of refunds to customers and business entities.

In respect of imports from other SACU countries and countries other than SACU countries, VAT is charged if such imports were not chargeable to VAT in the country of origin or where value is added (but are chargeable to VAT in Lesotho) and where the importer fails to produce a VAT invoice to show that VAT has been paid on the imports. This means that in these situations the VAT which applies is of the country of origin or where value is added except in cases where the country of origin did not charge any tax, therefore, the destination principle applies in the sense that Lesotho will impose its own VAT. In the same way, where the importer fails to produce a VAT invoice as evidence to show that VAT has been charged by the country of origin (or country where value is added), Lesotho will charge VAT on the basis of the destination principle.

6.3.3 Strengths and Weaknesses of the VAT Administrative Arrangements on Cross-Border Transactions between Lesotho and South Africa

The VAT administrative arrangements between Lesotho and South Africa on cross-border transactions have to some extent been effective, while on the other hand the system has weaknesses. The strengths of these administrative arrangements can be identified as follows: - Firstly, the arrangements are mainly characterised by the collection of invoices (as evidence for payment of VAT in South Africa) from importers

into Lesotho, this has reduced (to some extent, though in some cases cash payments are still made) handling of money (cash collection) by the customs staff. Secondly, importers do not have to worry about making cash payments at the border, therefore this takes the burden off the importers to the administrators.

Thirdly, these administrative arrangements have contributed to efficiency in allocation and accrual of VAT as it does guarantee allocation of VAT to Lesotho as long as the VAT invoices which are submitted by importers are authentic. In this way, from Lesotho's perspective these administrative arrangements guarantee revenue from VAT charged on goods imported from South Africa.

Fourthly, these arrangements have also relied on the cooperation between the tax authorities in Lesotho and South Africa, therefore this tends to strengthen the relations of the tax authorities and the two countries in general. This cooperation in future can lead to the successful negotiation on how the system can be improved for the benefit of the two countries.

The fifth point which also indicates the importance of this arrangement is that the Lesotho Regulations excludes some imports from VAT. The small imports (from South Africa) which are below M250 can be imported without paying VAT at the border posts. However, one acknowledges that this limit needs to be increased in order to eliminate totally small imports from being taxed upon importation, so that they can be treated as tax paid.

On the other hand, these administrative arrangements can be criticised for the following weaknesses: - Firstly, the system tends to rely on invoices from the importers and consumers to support the claims of VAT from SARS. This means that if the invoices are a result of fraudulent activities between the importer and the supplier, LRA will not be able to secure any import VAT from SARS. Secondly, this system requires that the customs staff should be efficient in compiling accurate statistics and invoices. They should also exercise great care in checking the invoices to ensure that it meets the requirements of an acceptable invoice by SARS. This means that the customs officials should be well trained and skilled in how to undertake these tasks. Thirdly, the system also requires physical checking of imports (including even small imports) which can

require more resources in the form. It seems there is no distinction between small imports which would not necessarily contribute significant VAT and large imports. The system also requires more customs staff being deployed at the border posts. This can also result in long queues particularly where the staff is not well trained. The fourth disadvantage is that the system at the border posts is not electronically linked to the VAT headquarters office, therefore there is still delay in processing and compiling the invoices as the system is done manually.

In view of these disadvantages and as a way forward with the aim to improve the effectiveness of the system, it is recommended that studies should be undertaken which can draw examples from other countries and regions in such transactions in particular the EU VAT system. Reference to systems from other countries is by way of example and to draw analogies or lessons particularly on the application of a mixed system of taxation by both origin and destination principles.

6.4 The EU VAT System and Cross-Border Transactions in practice

The approach to this part of the study is to examine briefly the EU VAT system (to the extent that the taxation system is relevant to the VAT system on cross-border transactions between Lesotho and South Africa) in three stages which represent the adoption of different principles which are relevant to the VAT system since the harmonisation of VAT within the Community. Reference to the EU VAT system is by way of example in examining the use and adoption of both the origin and destination taxation in cross-border transactions within member states of an economic grouping. The extent to which the position in the EU is comparable to the position between Lesotho and South Africa is that in both cases the countries involved belong to a customs union or common market (which is some kind of a customs union) and the significance of the taxation principles in cross-border transactions underlies how VAT applies to such transactions. In that respect, each of the systems can learn (in areas which can benefit the efficiency of their individual systems) from each other particularly in the administration of VAT in cross-border transactions.

Furthermore, it is important to acknowledge that the EU (member states) constitutes a different economic and geographical setting from the position between Lesotho and South Africa, there are differences of rules and to an extent the nature of some cross-border transactions. However, the nature of the international taxation principles in both cases is the same. Furthermore, the other difference is that in the EU the VAT system applies to a large number of states and this differs from the position in Lesotho and South Africa since the administrative system on how to charge VAT on cross-border transactions applies between the two countries only (SACU member states have not yet adopted a common VAT system).

6.4.1 Period after Harmonisation of VAT Systems in the EU: Prior to the Abolition of Tax Frontiers

The process of harmonisation of the VAT systems within the EU member states was considered important for achieving full integration within the Common Market. The primary objective of harmonisation was to abolish 'cascade' turnover tax systems which some member states had in place. Furthermore, the abolition of tax frontiers and the abolition of border controls in the EU were regarded to be at the centre of harmonisation of VAT systems and the completion of the internal market. The removal of tax frontiers was to eliminate differences which existed between the indirect taxes of member states."³⁷⁵

Prior to the abolition of tax frontiers in 1993, the EU VAT system taxed cross-border transactions (and transactions within the EU) on the destination theory.³⁷⁶ In terms of this theory a business entity exporting a product for example, from France to the UK paid VAT at the rate which applies in the UK (immediately as the product is brought into the UK). Similarly, if a consumer from the UK purchased a product in France, they purchased it at a tax-free price but paid the VAT of the United Kingdom (as

³⁷⁵ Easson, A.J., "Tax Harmonisation in the EEC: The Commission's Programme" *British Tax Review* 1981 p.329 at p.330

³⁷⁶ In accordance with this theory, tax was levied on imports. Exports were zero-rated in member states in respect to all taxable transactions and the business entities were entitled to recover tax paid on imports

they crossed the border into the UK with their purchase). For this system of taxation to work effectively it requires the existence of border controls.

The effect of this system was that the member states' VAT systems ended at their national boundary as each member state was responsible for the enforcement and collection of VAT within their own jurisdiction. The other significant point which is relevant from the use of destination taxation within the EU member states is that the administration of VAT remained the responsibility of each individual country. However, after harmonisation of turnover taxes, the destination taxation appeared to be incompatible to the harmonisation process and integration within the Common Market. This resulted in the move towards the abolition of tax frontiers within the EU.³⁷⁷

6.4.2 The Transitional EU VAT System

The adoption of a transitional VAT regime by the EU was intended to be temporary with the intention of moving to a definitive regime after a few years time. (However, this system still applies in the EU VAT system today.)³⁷⁸ The member states adopted the transitional system with a mixed application of the destination and the origin theories. The destination theory is retained for transactions involving VAT-registered business entities in the member states. The origin theory is introduced for all cross border supplies to persons outside the VAT system which includes final consumers and exempt business entities. The effect of the origin taxation rules is that cross-border purchases by private persons and final consumers are now taxed in the member state where the final purchase is made (this can either be the state of origin or an intermediate state where production was completed or further value was added to the product).

The removal of fiscal frontiers and border controls in the EU has resulted in abolition of the physical checks of the goods; the submission of invoices; and the

³⁷⁷ The abolition of tax frontiers and the partial abolition of border controls in the EU were achieved in 1993

³⁷⁸ The Commission's proposal was to move towards the origin system of taxation, but its initial proposals were unacceptable to member states

payment of VAT at the border posts. The system of checks now has to be made internally within each member state.

The abolition of borders brought with it the change of terminology with respect to trade within the member states.³⁷⁹ The significance of this change is to make a distinction between the VAT treatment of transactions which take place between registered business entities within the Community and those which involved other parties; and to identify the relevant administrative procedures. Cross-border trade between registered business entities within the EU are taxed on a deferred payment basis. The deferred payment system requires the buyer of goods to apply the VAT to his purchases from abroad and, at the same time to take credit for that VAT, all in the same VAT return.

Apart from the new administrative arrangements which were introduced, different rules (special schemes) were designed to apply to other transactions dealing with taxable supplies to final consumers and non-taxable entities.³⁸⁰

The taxation of transactions between the EC countries with third countries is not affected by the abolition of tax frontiers. Transactions with third countries continue to be taxed on a destination principle.³⁸¹ The present requirement is that business entities should register for VAT in every Member State in which they know that they will carry on business and engage in taxable transactions. This enables them to be able to reclaim input tax and refunds on exports.

³⁷⁹ The notions 'import' and 'export' were regarded as no longer appropriate and were replaced by the new terminology 'intra-Community supply' and 'intra-Community acquisition' in reference to trade transactions within the Common Market. This was in accordance with the full integration which was achieved by the member states and the fact that the member states were no longer restricted by border controls. Effectively, they cannot be 'importing' or 'exporting' to each other as they are part of a common system

³⁸⁰ The EU designed separate rules with the aim to regulate cross-border shopping (which resulted from the fact that VAT rates are not yet harmonised) by private persons and other non-taxable entities across member states. Therefore, member states introduced restrictions to regulate purchases by non-taxable business entities and private persons in transactions where VAT is charged on a destination basis in relation to the following transactions: - (1) Tax-exempt legal persons, such as hospitals, banks, and public authorities; (2) Distance selling Transactions; (3) New Means of Transport; (4) Triangular Transactions

³⁸¹ This means if goods are imported into one country in the EU, they are taxed in the country of first entry within the Community. Business entities are required to keep detailed records of purchases from and sales to other countries outside the Community.

6.4.3 Difficulties in Implementing the Transitional System

(1) The need for border controls: - Under the destination theory imports are taxed but exports are treated as tax free. This requires border tax adjustments in the sense that evidence of exportation of the products is required, since VAT must be removed from products leaving the state and added when the products enter the importing state.³⁸²

(2) Zero-rating exports: - The most common way of implementing the destination theory for VAT involves zero-rating exports and taxing imports. This has proved to be more vulnerable to fraud and result in loss of revenue since a lot of goods tend to be diverted back into the domestic market and circulate free of VAT. According to Ebrill, in the EU for instance, around EUR 70 billion goods circulate free of VAT.³⁸³

This risk of fraud arises from the possibility that goods may be supplied to another member state and sold without the customer ever accounting for VAT. For the administrative system to cross-check the movement of the goods and control the fraudulent practices against zero-rated goods, business entities are required to obtain details of the VAT numbers of their customers in other member states. They have to submit a quarterly listing, aggregating their total sales to each VAT-registered business entity in other member states. However, this system has proved to lack strong enforcement mechanisms and has resulted in fraud.

(3) Cross-border movement of goods: - This results from lack of approximation of VAT rates within the EU member states and is likely to cause cross-border shopping. In practice consumers take advantage of cross-border shopping in a country with lower rates and bring back tax-paid items from the neighbouring countries, especially where the tax rates differ greatly to the tax rates in their own country. This may be likely to be the case in respect of luxury goods such as perfumes and alcoholic

³⁸² The tax rate which applies is the rate of the importing state

³⁸³ Ebrill, L., et.al., *The Modern VAT*, op.cit. p.184

products.³⁸⁴ The other example which can be referred to is the cross-border shopping between Denmark and Germany.³⁸⁵

(4) The requirement that trade transactions between registered VAT business entities should only be taxed in the destination country seems to raise a number of problems. Since the goods can no longer be traced through the borders, this means foreign business entities have to pay tax in the country of destination. Therefore, this has resulted in business entities being required to register in a country of destination. This means they have to have a tax representative in countries which they do not carry out any trade.³⁸⁶

(5) Another difficulty relates to which state the revenue accrues to. The country which exempts its exports from VAT automatically loses the revenue, and this revenue accrues to the country that acquires the goods. That country charges VAT on the goods which is equal to the VAT borne by similar domestic goods. It can be concluded, therefore, that under the present EU system of taxation, the VAT revenue on an exported

³⁸⁴ Keen, M., and Smith, S., "The future of value added tax in the European Union", op.cit. p.382 reference to study by Fitzgerald, J.D., Quinn, T., Whelan, B., and Williams, J., "An Analysis of Cross-Border Shopping" Paper 137, 1988 (Dublin: Economic and Social Research Institute) For example, this study reported that it is estimated that "in 1986 about one quarter of all spirits drunk in the Republic of Ireland were bought in Northern Ireland." (It also became evident that the Republic of Ireland has significantly higher rates of indirect taxation than Northern Ireland. These resulted in cross-border shopping in Northern Ireland by consumers from Republic of Ireland, with items such as petrol, foodstuffs and groceries being purchased more frequently. The findings of the study also showed that the cross-border shopping was mainly one way, with a small volume of cross-border shopping in the opposite direction which concentrated particularly on clothes. The other significant point which came up from this study is that the impact of cross-border shopping will be more significant with people who live near the border areas. (See Fitzgerald, J.D., Quinn, T., Whelan, B., and Williams, J., 1988, quoted in Bygva, S., "The road to the Single European Market as seen through the Danish retail trade: Cross-border shopping between Denmark and Germany" *International Review of Retail Distribution and Consumer* 1998 Vol.8 No.2 pp. 147-164 at p.148)

³⁸⁵ It appeared that the reason which influenced the cross-border shopping from the Danes' perspective was that many items were cheaper in Germany than Denmark. This was mainly caused by the high rates of VAT and excise duties in Denmark, particularly in respect to cigarettes, sweets, beer and wine. In the same way, the Germans considered the price of diesel oil cheaper in Denmark than in Germany

³⁸⁶ It can be argued that this is a disadvantage to business entities, particularly smaller ones, which do not have the resources to register in every member state and even to meet the obligations of the VAT system in those countries. They are required to be conversant with different VAT systems of the member countries and have knowledge of the different languages in different member countries. Where the business entities lack expertise in both the VAT legal requirements and the language in any of the member countries, they have to appoint a tax representative in the country concerned to help them with simple procedures of completing and filing the VAT tax form. These will have an impact on compliance costs of the business entities

product does not entirely accrue to the state where the value is added.³⁸⁷ The issue of which country receives revenue is a sensitive one to the member states and countries always want to guard against revenue which accrues to them.

The outlined difficulties which face the destination taxation in the EU have led to considerations to move to a definitive regime³⁸⁸ and adoption of origin system. This system however has been under consideration for sometime, but it has not been adopted up to date. The principles of the definitive regime are:- (1) A single place of taxation for each business, (2) Abolition of the current arrangements for zero-rating of exports, (3) Macro - allocation of revenues, (4) Uniform base and rates, (5) Administrative co-operation, (6) Taxation in accordance with the origin principle.

Some economists have argued that a switch from the destination system to the origin system without harmonisation of VAT rates will not make much of a difference to address the concerns under the destination taxation. For example, Sinn notes that, "Unless VAT rates are sufficiently harmonised, massive waves of cross-border purchases must be reckoned with...(T)he only way to ensure that, despite the direct purchases, net of tax prices continue to be equated across borders seems to be a harmonisation of tax rates".³⁸⁹

³⁸⁷ Tait, A.A., *Value Added Tax*, op.cit. p.17 - The following example can be used to illustrate the point above:- if an article is manufactured in country A (the UK) and the process of production is completed in country B (France) and it is subsequently exported to country X (China, which is outside the Community), if the value added in each producing country is 100 and the tax rate in each is 10 per cent; under an origin system the UK will receive 10 in tax revenue and France will receive nothing (exports outside the Community being zero-rated) and it will give a credit for the tax paid in the UK. By contrast under the destination principle, neither the UK nor France receives any revenue as revenue accrues to China. Furthermore, if an article manufactured in China is imported into the UK, finished or packaged there and then sold in France, the UK will receive tax revenue in respect of the value added in China, as well as within its own jurisdiction.

³⁸⁸ Under this regime, exports by registered traders would be subject to the VAT of the country of production, but a tax credit for an equivalent amount would be granted to the registered importer by the country of destination – see Cnossen S., "Global Trends and Issues in Value Added Taxation" op.cit. p.412 note34

³⁸⁹ Lockwood, B., de Meza, D., and Myles, G.D., "On the European Union VAT Proposals: The Superiority of Origin over Destination Taxation" University of Exeter 1994 p.6

6.4.4 Strengths of the EU VAT System: The Transitional System

The advantages and strengths of the present EU VAT system are characterised by the abolition of border controls in member states. The fact that administration of VAT has now been moved internally within the member states means that the collection of invoices and payment of tax is done at one point. This means the issue of delays of collecting tax at the border posts does not arise, as it is the case in Lesotho.

The other advantage of this system is that since tax is only paid internally there is efficiency in regulating the movement of the revenue by the administration. There is no cash collection at any other area, therefore, there is greater efficiency in control and regulating the revenue collected. This reduces corruption and misappropriation of revenue by the authorities responsible.

6.4.5 Why Has the Definitive Regime (Origin System) Not Been Adopted in the EU?

The definitive VAT regime has not been adopted within the EU to date as a result of disagreement in certain areas which underlie the effective operation of the system. The member states have not reached an agreement for example on the issue of harmonisation of VAT rates. This has resulted in wide discrepancies in tax rates for major categories of goods and services. This issue of harmonisation of tax rates is a political issue within the member states and it is a sensitive issue as well. As the issue concerns an increase of tax rates in some member states, while in some states tax rates have to be reduced, it affects the broader economic, political and social issues of setting tax rates in each individual member state.

Another issue on which the EU member states have not reached agreement relates to allocation of revenue amongst the member states. The proposed origin principle requires an establishment of a clearing mechanism of VAT which is due to the member states. Since it would not be possible to settle VAT payments on a transaction by transaction basis, the tax will be collected in each member state and will have to be

distributed and allocated at a later stage amongst the member states. However member states have not reached an agreement on the method to be adopted for allocating the revenue. Furthermore, for this system to work efficiently it means the member states would have to give more rights and independence to the Commission to deal with the allocation of revenue and it seems member states are reluctant to do so.

6.5 Introduction of a Common VAT System within SACU Member Countries: Lessons to be learned by SACU

Some member states of SACU have had a VAT for a number of years. For example, South Africa introduced VAT in 1991 while Namibia introduced a VAT in 2000. Botswana introduced VAT in July 2002 while Lesotho introduced VAT in July 2003. Swaziland has been considering replacing its general sales tax with a VAT.

Though these countries are members of a customs union and have an agreement which regulates their excise and customs duties, a similar agreement does not exist in respect of turnover taxes like VAT. Each country has adopted its own VAT system, though it appears that the South African VAT system is likely to have had an impact on the VAT systems in the other member states. (It can be assumed that is the case because South Africa is the first country within the customs union to introduce a VAT and it has the largest economy and trade with the others). Furthermore, the VAT rates of all the member countries are within the range of 10 per cent to 14 per cent standard rate.

All the member states have a destination based VAT system. These countries maintain their borders posts and this means that the issue of VAT remains a matter for individual countries within SACU. However, with closer economic integration between countries, inter-jurisdictional issues on questions of indirect taxation are becoming a concern. As a result member states will have to rethink their policies on VAT and how it affects cross-border trade amongst the member states within the region.

The other important considerations for the future as a way to enhance the issues of cross-border transactions and VAT would be to consider the treatment of small

imports between the member countries in order for the authorities to concentrate on larger imports where significant revenue is collected.

Furthermore, lessons can be learned from the EU deferred payment system which seems to be working well within the member states (this system is similar to the reverse charge mechanism that some countries apply to services from abroad).

Furthermore, as a way to resolve the current border post problems of administering VAT in Lesotho, the Lesotho and South Africa system (including other SACU member states in future) can consider abolition of border controls for purposes of imposing VAT. This would eliminate collection of revenue at the border posts which would resolve the problem of border delays and corruption of the revenue officers as VAT would only be collected internally. These countries would move the administration of VAT internally and this would enhance efficiency since the administration of VAT would be the responsibility of the main head office only. This means problems such as the delay in communication between the border post office and the head office, and the delay in transmitting the invoices would be resolved.

6.6 Conclusion

The EU VAT system represents an example of a VAT model within a group of states (in a common market) which are intending to move towards full integration of their indirect taxes. This system demonstrates how the principles of taxation apply in cross-border trade transactions. Both the destination and origin principles tend to be undermined by various problems particularly where the countries involved in cross-border trade within a customs union or a common market have not adopted harmonised VAT rates.

On the other hand, the discussions highlight the potential problems which arise from cross-border trade transactions. It seems that cross-border trade transactions tend to raise challenges to the administration of VAT. This is clear from the various problems which are discussed in the context of the administration of VAT in cross-border transactions in Lesotho and examples from the EU VAT system. It can be argued that some of these problems can be overcome by adopting a mixed system where the two

inter-jurisdictional principles are applied. This view finds support from the fact that the above discussion reveal that where one of the principles is adopted there are more problems which exist (particularly in a common market) as opposed to where the two are adopted to apply to different transactions.

The main focus in this study is on the taxation of cross-border transactions which have particular relevance to the implementation and administration of VAT in Lesotho. The important factor in the nature of cross-border transactions which take place in Lesotho is that these are mainly dominated by South Africa, in the sense that the majority of the cross-border trade transactions are between Lesotho and South Africa. This can either be viewed as a negative point towards the cross-border issues in Lesotho and the problems which results as discussed; or as a positive point in the sense that, in terms of regulating cross-border trade transactions between Lesotho and South Africa, this can be easily achieved since two countries only are involved and as a result of the unique position of Lesotho, there is an absolute need to make special arrangements between these two countries without including the other SACU countries. These two countries also have to focus more on greater emphasis on tighter controls to avoid fraud and smuggling.

**PART IV GENERAL CONCLUSION: THE FUTURE OF VAT IN
LESOTHO**

This chapter deals with the general conclusion of the study. The chapter explains the approaches of research which have been adopted to investigate the inquiry of this study. This inquiry is summarised into different themes which are identified in preceding chapter and these are discussed in the context of the main theme of the study.

In the introductory chapter it is argued that the geographical situation of Lesotho tends to limit the country's options on its economic and taxation policies, in the sense that any policies which differ greatly from the neighbouring South Africa would result in many different problems. Furthermore, Lesotho is a member of a number of regional organisations, for example SACU and CMA. Therefore, Lesotho's economic and taxation policies have to conform to the obligations arising from such organisations.

Part One emphasizes the importance of the design and structure of VAT which has resulted in the tax being favoured by most countries and being recommended over sales taxes (in particular) by the IMF. This has also seen the implementation of VAT in Lesotho in place of a general sales tax. The structure of the sales tax system in Lesotho and its failings form an important theme in this part.

Part Two of the study focuses on the different aspects of the VAT system in Lesotho. The main question in this part is why the government of Lesotho moved from sales tax to a VAT; and to analyse the implementation and administration strategies of the VAT legal system since it was introduced.

Part Three highlights issues of cross-border transactions and how VAT is imposed on such transactions. The discussion highlights the general cross-border issues which underlie the VAT system in Lesotho.

The main arguments which are the basis of this study are: - Firstly, I argue that the geographical position of Lesotho (as a landlocked country) is a major determining factor to the taxation and economic policies which are adopted in the country. This argument finds support from the fact that landlocked countries rely on its neighbouring country (or countries) for access to cross-border trade with third countries and other

economic activities. Therefore, in that way, the options of a landlocked country in nearly all aspects are restrained. In this particular study the relevance of this point is seen in regard to the implementation of VAT in Lesotho. It is argued that the introduction of VAT in Lesotho was influenced (amongst other reasons) by the fact that the tax had been adopted in South Africa and in other countries within the Southern African region. On the other hand, I argue that the structure of the VAT system in Lesotho is also highly influenced by the structure of the VAT system in South Africa. This argument finds support from the point that some of the principles which are part of the structure of the Lesotho VAT legal system also form part of the South African VAT legal system. Most importantly is the issue of VAT rates. The standard VAT rate in Lesotho is set at the same rate as the standard rate in South Africa, and this is acknowledged by the government authorities in Lesotho as a significant development which is intended to address the problem of smuggling of goods and high rate of cross-border shopping.

The second argument in this study is that VAT has more advantages as compared to a sales tax. However, it is also highlighted that a sales tax does have some advantages over a VAT, though it seems there has been a shift in most countries from a sales tax to a VAT. It seems the structure and the design of VAT is attractive to most economists and countries. Furthermore, it seems that some countries particularly developing countries have introduced VAT because of its self-enforcing (self-assessment) principle which is crucial to the administration.

The third point which is raised in this study is that in most developing countries (Lesotho included), the introduction of VAT has been part of a broader issue of tax reform and strengthening of tax administration. This finds support from my analysis on the role of the IMF in tax reforms in developing countries which have focused particularly on the implementation of VAT. Therefore, I argue that in the case of Lesotho, the IMF played a leading role towards the implementation of VAT while at the same time recommending that tax administration needs to be strengthened. Furthermore, from my analysis and discussion on the change of an administrative structure and the establishment of a national revenue authority in Lesotho (and other developing countries which are referred to by way of example), it is clear that the intention was mainly to

strengthen tax administration with the aim to implement VAT. The importance of this latter development is that it marks a shift in Lesotho of moving tax administration from government control under the MOF to a semi-autonomous institution. As indicated it seems this style of tax administration has dominated the recent tax reform activities particularly in developing countries.

The fourth point which this study raises is the issue of VAT and small businesses with particular emphasis in an economy which is dominated by an informal sector. This would include farmers, small business entities, and street vendors which are not part of the VAT net since they are excluded from the tax. The issue in deciding which business entities should be part of the VAT system is determined by the level of threshold (minimum threshold) which the government set. However, those business entities which are below the threshold are permitted to register for VAT voluntarily. On this point, I argue that though small entities can register voluntarily to be part of the VAT system, there should be a limit to the extent which such an option can be exercised. The argument towards this point is that, if the VAT system permits all the small businesses to register, this can result in a number of problems. Particularly it can have an impact on the administration costs towards policing the business entities and also in policing refunds claims. The case of the number of voluntary registrants is highlighted with the use of statistics on cancellation of registration in Lesotho and I highlight the range of turnovers of those business entities. This point is taken further by analysing the reasons of why some of the small business entities in Lesotho decided to register and to consider that in the context of the general problems which face the small business entities under a VAT system. In view of the problems which these entities are faced with in Lesotho it is recommended that those small business entities whose turnover falls 'too far' below the minimum threshold should be restricted from being part of the VAT system.

The fifth point which is made in this study relates to the question that VAT has the potential to raise more revenue than a sales tax or other predecessor taxes. In the case of Lesotho, this point could not be established with precision since it was not possible to access the sales tax revenue records. Therefore, I could not undertake a well informed comparison of the revenue collection under the two systems. However, despite that

shortcoming, I highlight the level of revenue which has resulted from VAT since it was introduced with particular emphasis on VAT which is collected on imports.

The sixth point which this study argues relates to the general administration of VAT and administration of VAT in regard to imports and exports (cross-border trade transactions). It emerged from the survey that the administration of VAT is not much different from the administration under the sales tax regime. There were great concerns with the administration staff in general in relation to all of the staff at the VAT headquarters, customs officials at the border posts and administration staff in other districts.

The Seventh major issue which came up in this study as an administrative issue concerns the cheating and smuggling of goods which occurred at the border posts. This concern underlies the administration of VAT at the border posts. Following from this point, I argue that tighter measures and procedures should be introduced by the administration to deal with such cheating while at the same time the administration staff should be more accountable.

7.1 Review of Main Questions and Theme of the Thesis

The approach which is adopted in this study in trying to answer the main question which underlies this thesis is to examine the various theoretical sources and references on the principles of VAT. The approach was extended by undertaking a fieldwork research in order to investigate the practical issues which arise in implementing VAT. The issue which arises is whether this approach has been sufficient in investigating the main theme of this study. From the arguments and the analysis of the principles of VAT, it is submitted that the implementation of VAT and its administration in Lesotho to some extent has been successful. This can be supported by the fact that the implementation process was completed within a preparation period of about 6 months and VAT was introduced as planned by the administration. At the time of implementation the basic legislative acts had been passed and they formed the authoritative instruments to the VAT system. Though some of the preparation measures continued beyond the time

when VAT was introduced, the majority of the initial processes were completed. Furthermore, the fact that the implementation of VAT was not met with any resistance from either the business community or the public to some extent represents a successful implementation from the administration side.

As a result of close proximity of Lesotho to South Africa (and due to cross-border trade and shopping which takes place) business entities and consumers in Lesotho had an experience of dealing with VAT in South Africa to some extent. Therefore, though VAT was not part of the Lesotho tax system, some people and business entities had come across the tax before. This is seen from the number of vendors that complied with their obligations in the first period of introducing the tax.³⁹⁰

On the other hand, the administration of VAT was undermined by problems at the time of implementation. The main problems which emerged are that: - first, some of the VAT and customs staff gave different advice to the business community on the procedures of dealing with VAT both at the border posts and at the VAT offices. As a result in some cases, the business community were not well informed of the correct procedures when they were importing large quantities of items or cars and how to pay tax or claim any refunds. This shows that some of the VAT (and customs) officials were not clear and conversant with the VAT system and this is likely to change when VAT has been in place for a longer period of time. In order to improve this area of administration, training of staff including customs officers should be a continuing exercise in order to ensure that they know their responsibilities and can be able to communicate the correct legal position of the system to the business entities.

The second problem which emerged relates to registration of small business entities and some kind of 'fictitious' business entities. When VAT was introduced there were a lot of small business entities that registered for VAT, but later on could not cope with their obligations under the tax. Some of them just 'disappeared' from the registration list while some of them were deregistered. In the same way, the administration discovered that some of the registered business entities did not exist, nor

³⁹⁰ See chapter 5 on the discussion of submission of tax returns

could they trace them to their registered addresses. The challenge which the administration had to deal with was to establish whether these business entities exist or not. This would involve tax inspectors visiting the business premises and also to scrutinise the records to see which businesses had been filing their tax returns since they registered and which ones had not. This is one area of administration which the Lesotho administrators have to concentrate on. Though small business entities are allowed to be part of the VAT system, the administration has to draw a line as to which of these can register in order to avoid the problems mentioned above. Another recommendation is that tax inspectors should engage in regular visits to the businesses as a way of verifying some of the registration details. These visits can initially be focused on the small and medium business entities and if there are sufficient resources, periodic visits should also be made to the other business entities.

Thirdly, the other problem which the administration has to deal with is the issue to achieve efficiency in charging VAT at the border posts and other points of entries such as the airport. This is an important area where there is potential to collect substantial import VAT. However, the administration should ensure that they reduce or overcome the problem of smuggling of goods which can have significant impact on administrative efficiency and revenue efficiency. There is no doubt that as long as there is a difference of VAT rates on some items between Lesotho and South Africa, smuggling will continue to exist. This issue is significant for cross-border purposes under the Lesotho VAT system. It can be presumed that the level of smuggling is equated to the level of cross-border shopping which takes place. Therefore, there is need that both the Lesotho VAT authorities and the South African revenue authorities cooperate in dealing with this issue of cross-border shopping and smuggling. The customs officials have to establish a strong cooperation link and exchange of information at the border posts. They also have to cooperate in checking the goods (and invoices) which cross the borders.

The issue of cross-border transactions and how VAT applies is an issue which is going to expand and develop within the SACU member countries. The introduction of VAT with the same rate (and the same exclusions and zero-ratings) to similar goods in

all the SACU member countries will not be easy to achieve in the near future. The reason is that the different member countries have different economies and therefore, the design and structure of domestic VAT systems is mainly determined by existing circumstances within the countries. Therefore, while the different member countries have different tax systems, the problems which are highlighted in chapter 6 will continue to exist. In this way, Lesotho and South Africa will have to continue to make their own arrangements which apply in the two countries.

Furthermore, In the case of Lesotho and South Africa, the problem of smuggling in particular can be addressed by aligning the zero-rate and the extent to which it applies to basic food items. However, on the other hand one is aware that the need to introduce a zero-rate both in South Africa and Lesotho might have been dictated by different factors. Therefore, it will not be an easy process to negotiate to align the extent to which a zero-rate applies to basic food items.

The problems which are likely to come up in future in respect of cross-border transactions are ones which relate to supplies of services through the internet or the use of other technological means. In general it is difficult to apply VAT to services which have an international character or which originate from one country and are used or consumed in another country. This area of tax law will be more challenging to Lesotho which does not have enough resources to follow through the transactions. The challenges that Electronic Commerce has brought in recent developments of modern technology and the challenges it pose to VAT have been discussed by various writers.³⁹¹ As is difficult to trace the actual consumption with respect to services rather than it is with goods, rules have to be adopted for dealing with the challenges this issue poses.

Furthermore, with further integration within SACU and future harmonisation of VAT laws, this will open avenues for business entities to easily establish trade networks with other business entities and customers in other member countries. Therefore, in this respect there will be need for revenue authorities in member states to cooperate and to

³⁹¹ Van Der Merwe, B.A., "VAT and e-Commerce" *S A Mercantile Law Journal* 2003 Vol.15 No.3 pp.371-387; Silver, M., "The direct and immediate purpose test for Value Added Tax" *Acta Juridica* 2002 pp.208-219; Teather, R., "Reverse Premiums and VAT – return to the beginning" *British Tax Review* 2004 No.1 pp.37-45

exchange information on different aspects of cross-border transactions. There is likelihood in future to find problems such as the ones which exist within the EU which relate to 'carousel fraud'.

The other problem which is likely to come up in future in cross-border issues will relate to the movement of goods in taxable transactions which concern parent companies and subsidiary companies which are situated in different SACU member states. The revenue administrators will have to guard against any practices of fraud where the companies can be able to enter into transactions with their related or subsidiaries in different countries as a means to take advantage of the different tax rates which exist. As far as services are concerned, transactions between related companies can be very difficult to prove where they actually originate or whether the service was in anyway supplied.

7.2 Conclusion

The introduction and implementation of VAT in Lesotho has been successful. This point relies on the general administrative measures which were adopted to implement the tax (before and after the tax was introduced). This study reveals that the introduction of VAT in Lesotho partly resulted from the administrative problems which undermined sales tax. This affected the efficiency of the system particularly its failure to bring the majority of the business entities into the tax net and resulted in affording different treatment to these business entities. The implementation of VAT in Lesotho has been able to address and overcome some of the problems which sales tax was criticised for. Therefore, this achievement shows that the introduction of VAT in place of a sales tax was a good step by the tax administration.

On the other hand, it can be argued that the Lesotho government could have considered the option of strengthening the tax administration under the sales tax without necessarily having to replace the system itself. This argument finds support from the advantages of a sales tax, particularly in respect to the issue of costs since sales tax is cheaper to administer and to comply with than VAT. However, I should also not

overlook the other advantages of VAT over a sales tax. On the basis of this theme, I wish to recommend that since the change of regime from sales tax to VAT has already taken place and VAT has been implemented for a period of 4 years and 3 months (to October, 2007), the way forward is to strengthen the administration of the tax with the aim to achieve efficiency and ensure to establish an effective communication link with the business entities.

In regard to the investigation of the main question of the thesis and the approach which is adopted to investigate the main themes, it is argued that the thesis is successful in investigating the question whether 'it was a good thing that VAT was introduced in Lesotho'. This thesis has been able to show that despite the geographical nature of a country and the level of development, VAT as a tax can be structured and designed in such a way to suit and fit within the economic, social and cultural settings of a country. This thesis has been able to identify the main issues which led to the change of regime which saw sales tax being replaced by VAT in Lesotho. The development of the themes and arguments which underlie the main focus of the thesis is clearly identified. The successes of the study as well as the problems are clearly identified and recommendations of what needs to be done in order to improve the system and to address the problems are also highlighted.

The other important aspect which shows the point that the thesis is successful in investigating the main question is the approach which is adopted to deal with the major themes of the question. The involvement of both the administration and the business entities in investigating the main themes of this thesis has contributed to the success of the research. The use of data and information which was collected from the various sources is interpreted through individual arguments while at the same time I refer to the relevant principles and relevant legislative provisions. This approach contributes to the originality of this research work. Though varying views towards the implementation and administration of VAT in Lesotho were raised during the fieldwork research, in general it seemed that VAT is a good system of tax and what needs to be addressed are the administrative problems and challenges which have been identified.

There will be a need in future to take this study further and look into specific aspects of the contribution of VAT to the revenue collection in Lesotho. Furthermore, it will be interesting to investigate the administrative aspects of the VAT system after a period of 5 years to find out whether it has improved or changed from how it was working and perceived during the initial period of implementing VAT. The other administration issue which needs to be taken further in the case of the VAT system in Lesotho is to examine and investigate the LRA as an institution. It is important to carry out an intensive study on LRA and its activities and whether it has actually achieved its administrative objectives and the extent to which it has been successful in solving the problems of tax administration in Lesotho.

Lastly, it is important to highlight that the latest developments in international trade transactions have seen the global mobility of both goods and services and this has brought with it new challenges which will have to see tax policy reviewed. These are likely to prove challenging to developing countries and this will add to the problems they already face in domestic implementation and administration of VAT.

QUESTIONNAIRE TO THE BUSINESS COMMUNITY

NAME OF BUSINESS (OPTIONAL).....

1. What kind of business are you engaged in?

.....

2. Were you required to register under the General Sales Tax (GST) Act?

YES OR NO

3. Are you required to register under the present VAT Act?

YES OR NO

4. What is your minimum turnover of taxable supplies of goods and services?

.....

5. If registered and not required by the law to do so, why did you decide to register?

.....

6. Since July 2003, how often have you submitted tax returns and made payments to the VAT office?

.....

7. Were there any significant compliance costs experienced by your business in the changeover from GST to VAT? Is the administration burden any simpler under VAT for small businesses? **YES OR NO**

Can you briefly but clearly set out the costs under both tax systems?

.....

8. What has been the effect of VAT on your prices? (include goods and services taxable at different rates and zero-rated items)

.....

9. What has been the effect of VAT on your production process?

.....

10. Has there been any effect of VAT on the level of your imports of goods and services from other SACU countries? Has your level of imports declined or increased or have there been other changes? If there has been a change, why do you think this has happened?

.....

11. Has there been any effect of VAT on the level of your exports? Has your level of exports declined or increase or have there been other changes? If there has been a change, why do you think this has happened?

.....

12. The border post situation - what has been the effect of the introduction of VAT at the points of import, for example, the border posts? Please give details of the level of service provided by the tax administrators.

.....

13. Please give your general views – on VAT as a tax, VAT and its effects on your business, VAT and its effects on other businesses, VAT and its effects on small businesses and VAT and its effects on those who intend to go into business.

.....

Thank you for your time!

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